



the Illinois Certified Public Accountant

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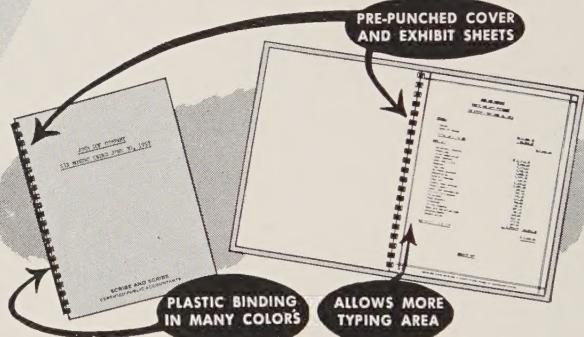
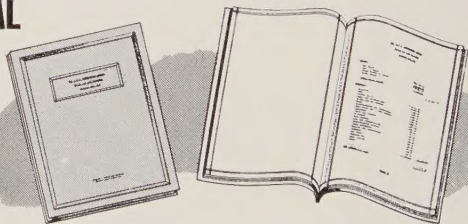


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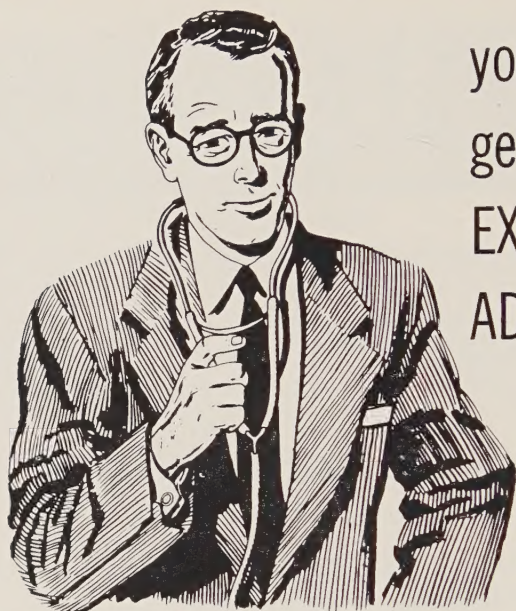
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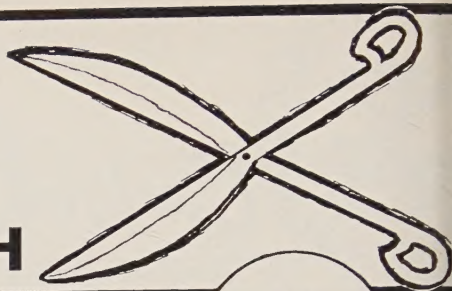
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PRESIDENT'S PAGE



What good is an annual meeting? Why do we have one? What can I get out of it?

These are timely questions to ask ourselves with our 1958 meeting all planned and ready to go in Peoria June 4-6.

A lot of our members didn't come to the annual meeting in Rockford 1956 nor to Chicago in 1957; and a lot of them will miss the Peoria meeting, too. I have heard most of the reasons, or excuses, which are often: "too busy" is the perennial favorite; a few even suggest they can't afford it. The late Mark Eaton points out so aptly on page 32 of the June, 1957, *Journal of Accountancy*, that "As a fundamental, ours is an intellectual occupation and one of

dignity. Its income [among other things] must provide for participation in the affairs of the professional societies and attendance at their meetings."

I'm sure these folks who stay away are missing a lot more than just an annual meeting. I think they're cheating themselves out of the stimulation, the camaraderie, the challenge, and some of the "feel" of our profession. An annual meeting is a lot of things—these among them—all tied up in one package, available to all of us for a modest investment of money, plus two and one-half days of time well spent.

In a nutshell, what does an annual meeting offer you or me and every other member? Here are some of the things—enough, I think, to make it a bargain, even for the busiest of us:

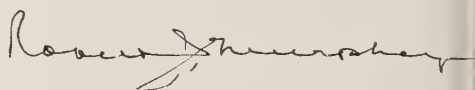
- (1) An opportunity to kick ideas around with fellow CPAs in a pleasant, informal atmosphere for a couple of days;
- (2) A chance to find out what the Society is doing about some of the profession's problems (and there are many) and to say what you think it should be doing about them;
- (3) Fellowship with a lot of good people, in both the business and social parts of the meeting;
- (4) Good technical sessions on timely subjects with stimulating speakers;

(5) A feeling that we are really a part of our profession — something mighty important to all of us — and that we are doing something to make it better.

Think it over. If you hadn't

planned to come, why don't you reconsider? There is still time to make your reservation by simply filling in the form on the next page and mailing it in today. I hope to see you too, in Peoria.

Cordially yours,

A handwritten signature in cursive script, appearing to read "Robert J. Murphy". The signature is written in dark ink and is positioned below the typed name "Robert J. Murphy".

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THE LIFELONG EDUCATION OF THE CPA

By MARQUIS G. EATON

Our subject here is education—education in and for the profession of accountancy.

Accountancy has its fair share of questions that are yet to be answered. One of them we can regard as of secondary significance and of such character that we can leave them for a time when we can conveniently reach them. In my opinion the question of what we are to do about education in accountancy is not one of these.

Wish I could find words to convey the deep sense of urgency I feel about this subject of education in the profession. It would be a fine thing indeed if someone could describe that urgency in words so clear, and in terms of logic so compelling, as to get on it the earnest attention of every single CPA in the United States. The profession has expanded very rapidly in numbers and in prestige, and, as a companion piece of this record, it is perhaps not strange that we should see some evidence of complacency. For example, we have worked hard and long to establish the CPA certificate as the mark of professional

status. It may be natural under the circumstances that we should tend toward the belief that the CPA designation is the be-all and end-all of professional competence. Though most thoughtful people know that this is not so, I think we should examine this misconception.

Considered from the standpoint only of *competence*, just what is a profession? It presupposes a subject matter, a science, that is broad enough to permit extensive learning, it might be said, of endless learning. *Is accounting such a science?* As we sometimes see it practiced, we would have to say "no." If we consider only the level of competence required by the CPA certificate, the answer would again be "no." It is my view, though, that the profession of accountancy is presently much more than this. I believe, too, that accounting, and the various skills that are logically based on accounting education and accounting experience, are only at the threshold of application in the affairs of business, and government—and, in fact, throughout the social order. Even now we find these skills applied

MARQUIS G. EATON delivered the address from which this article is adapted on May 16, 1957 at the Nineteenth Annual Institute on Accounting which was sponsored by the Department of Accounting, College of Commerce and Administration, The Ohio State University. It is reprinted here, with permission, from the Proceedings of that meeting. Mr. Eaton died suddenly on February 23, 1958. One of the profession's outstanding leaders, his services included the presidency of the American Institute of Certified Public Accountants, the presidency of the Texas Society of Certified Public Accountants, and the vice presidency of the Oklahoma Society of Certified Public Accountants.

in management, in various systems of taxation, as a check on fiduciary integrity through audit under a multitude of circumstances, in public regulation and supervision, in price determinations, in the fixing of property rights between parties, and so on through a long list that any of us could compile after reflection. There is no question that even now, in what must be regarded as a point near the beginning in accountancy, we can fairly consider accounting to be a subject matter which permits of endless learning. In the future it is easy to believe that accounting skills will be much more widely used. Accounting is a science which justifies and indeed requires a profession.

The CPA designation, what is it? It is a license granted by the states. In our American system, the licensing of the professions is the function of political bodies. It is not a function of the professional groups. Although all of the professions seek to raise to appropriate levels the minimum standards represented in the states' license, the license remains, still, as only the lowest common denominator. No calling can claim place among the learned professions solely on the basis of the states' license. Accountancy cannot claim place among the learned professions on the basis of the CPA certificate.

All of the questions we have in the areas of competence, of state licensing, and of education are complicated by the fact that accountancy has not clearly defined the scope of its activities and the probable direction of its future development. It is to be doubted whether we will ever have a clear and comprehensive definition. Instead, the profession will, in the course of time, evolve a general sense of direction that will be accepted by

most, if not by all. Rather than to attempt a definition, I want to try to present a general concept which may suggest an image to serve in place of definition.

I believe there is a place in contemporary affairs for a profession of business. This, in my terminology, is to be contrasted with a business profession, such as advertising. A profession of business will be one that observes the standards of the ethical professions of medicine and the law and accountancy in regard to advertising and solicitation and personal conduct; it will accept the burdens of perfectability on a broad range of business problems and will accept the responsibility for deep learning in this regard. It will accept a tradition of service and dedication of the highest order. It will move in the high places of business and government and in affairs generally.

I think that accounting is a science which pursued, not only for its own sake but as a foundation for other related skills in management, in finance, in government, and as a guide to the exercise of judgment, can and should have this kind of future. And when we lay our plans for education for an accounting career, it is that kind of career we should ultimately have in mind.

Education is such a very large subject that it is not possible to consider all of it at once. Some of the other professions have found it convenient to cut education into three pieces. First is the period of formal schooling, followed by the period of indoctrination for the profession, often regarded as the first five years after graduation, and then the longer period embracing the remainder of the professional man's life when the most advanced learning is acquired.

We have many pressing tasks in the next two periods to which we must give immediate attention. These are critical periods, and everything that occurs in the period of most advanced study must find its foundation in the two earlier periods of preparation. If, in my remarks, I emphasize the third and final period of study, it is with the intention of minimizing the learning that must occur before. It is only that it is not possible to tackle here more than one segment of the accountant's education, and even that must be discussed in very summary form. To put it in unkind terms for the sake of making a point, the two earlier periods, as vital as they indisputably are, must be classed in any man's life as the cub years and no man can expect to qualify as a learned member of his profession with this preparation alone.

Let us give attention now only to what I have called the period of advanced professional learning, which begins after the young accountant has become comfortably indoctrinated for his profession and continues throughout the balance of his professional life. This third and final period of learning is the one of surpassing importance to the professional accountant. If accountancy is to be composed of mature, seasoned, carefully formed people, this is when they will be produced.

What facilities do we have to assist the man who wants to study at advanced levels and who seeks this greater learning? We have a few graduate study conferences, almost invariably of short duration. We have some tax clinics. We have the meetings of our professional societies at which technical matters are customarily given part of the program. The American Institute has lately pre-

pared some material which local groups may, if they wish, organize themselves to study, and a few such groups have been organized. Though I may miss some things, this is about the sum total of the advanced study facilities available to the accountant.

How does this total compare with the facilities available to other professions? It compares in this way: we have less than the medical profession; we have less than the legal profession; we have less than the dental profession; we have less than life insurance agents; we have less than business management personnel; we have less than bankers. These I know about. There may be others. As a profession, our facilities for advanced study are in a sorry state of neglect. The question is, what can we do about it?

In our consideration of what might be done to improve our facilities for advanced study we first turn to the experience of other groups to learn what they have found to be useful, and to learn, too, what they have tried and abandoned for one reason or another. There we may find some procedures we can adopt, or can adapt to our conditions, and some things we need not try because they have already been shown to be unworkable.

As we examine various programs we should remember that, in the period of advanced study, any deficiencies in earlier training can and must be made good. We shall have to rely upon this period as the practical leveler or equalizer to compensate for any present deficiencies in collegiate schools of accounting, and, when these deficiencies have been repaired, we must rely upon it to lengthen the years of learning beyond the limits of even the best collegiate programs.

Our time limit permits mention of only a few points suggested by the experience of other groups, and the ones I will mention are of haphazard selection. Their only attraction is that, at first glance, they seem to suggest ideas that are worth exploring.

Organized programs for learning presuppose teaching in one form or another. The scarcity of university faculty and the general reluctance to teach on the part of accountants in practice are widely known. Both of these conditions might be improved if we could implant two attitudes toward teaching in our postgraduate programs. One is suggested by this quotation:

"I swear by Apollo the Physician . . . and all the gods and goddesses, that according to my ability and judgment, I will keep this oath and this stipulation: To reckon who taught me this art equally dear to me as my parents; to share my substance with him and relieve his necessities if required; to look upon his offspring in the same footing as my own brothers, and to teach them this art, if they shall wish to learn it, without fee or stipulation; and that by precept, lecture, and every other mode of instruction, I will impart a knowledge of the art to my own sons, and those of my teachers; and to disciples bound by a stipulation and oath according to the law of medicine, but to none others."

That is from the so-called Oath of Hippocrates which is still used in the graduation ceremonies of many medical schools and which is thought to be more than 1,700 years old. By it, the physician accepts, as a normal professional responsibility, the obligation to teach. And, from my observation of doctors, that obligation is quite widely honored in practice.

I can think of no reason why the accountant should not embrace a similar professional responsibility, nor can I think of a reason why this point of view should not be continually exposed until, by persuasion, it is generally accepted in the profession. Perhaps we should adopt a practice of conferring some marks of distinction or recognition on practicing accountants who have performed their duty under appropriate circumstances.

The second point having to do with teachers is this: There are two traditions which hamper all efforts to provide teaching personnel for our profession. The first is the tradition or custom in the profession that instruction shall be given for nothing or nearly nothing. We never offer honoraria to the speakers at our meetings. The other is the grand old American tradition that we should expect the teachers in our schools to find total satisfaction in a job well done and to expect little by way of a comfortable compensation while doing it.

I visualize a situation in which advanced study groups would expect to pay the reasonable cost of the instruction they received, and this cost would be accepted as including reasonable compensation of the teachers employed, whether these were taken from faculties of our universities or from the practicing profession. Under such an arrangement, many teachers from university faculties could earn a substantial annual supplement to their incomes. This would do much to solve some of the problems of the collegiate schools of accounting, while encouraging faculty to improve its offerings to advanced groups who, by selection, would create a somewhat competitive environment for this kind of work. Practicing accountants

ould have an inducement to prepare and perfect teaching material, particularly if it could be offered year after year at a fixed time and place for successive groups. Under present conditions, practicing accountants scheduled to speak on a subject to only one group and on only one occasion usually talk on lines so broad that to have value only in practice, and then they are not really well prepared.

Advanced study, in one of its senses, means reaching deeply into a subject. This prompts the observation that at the most advanced developments in any profession are the products of specialists. If a science is broad enough and deep enough to justify a profession, then it probably defies the ability of any one man to absorb it all. A profession, by definition, presupposes specialized divisions. Accountancy has done little or nothing to define and recognize appropriate divisions of specialization, and to this day, perhaps, be attributed the fact that accounting yet waits for exact and imaginative application in many places.

It may be difficult if not impossible at this time to divide accounting and related subjects into appropriate fields of specialization. Each such field should be large enough to absorb entirely the career of any individual who followed it. As a means of achieving the eventual establishment of normal fields of specialization, it might be advantageous for groups of individuals interested in various areas to organize themselves first into professional societies for the sole purpose of study, research, and exchange of information.

In the course of time, some of these might evolve into groups of examina-

tion and accreditation similar to colleges and the national boards known in the medical and dental professions. While the diploma mills of the past should be avoided at all costs, some means of conferring distinction upon accountants of proven advanced learning would seem to be desirable. Perhaps control of specialization, with the requisite professional societies and acknowledged distinctiveness of the specialist, could be achieved by recognition or nonrecognition of the accrediting groups by the American Institute of Certified Public Accountants.

However, a profession also needs to make available facilities for advanced study that are not highly specialized. In medicine, the American Academy of General Practice is organized for the general practitioner. For membership therein the Academy requires the doctor to complete at regular intervals a prescribed minimum of accredited advanced study. If he does not, he is dropped from membership. The accrediting of the study facilities is kept under close control. The purpose of the Academy is to raise the level of competence of doctors in general practice and to confer a mark of distinction on those who meet its requirements.

In the profession of law, continuing legal education is carried on by the American Law Institute. The Institute has had considerable financial assistance from the Carnegie Corporation, a type of encouragement that accountancy may expect eventually to receive. The Institute is an organization separate from the American Bar Association, though the program on continuing legal education is controlled as to general policy by a committee composed of twelve members from the Institute, eight from the

Bar Association and the presidents of the two organizations. The aim is to maintain permanently an over-all program of continuing legal education. Implementation is through state and local bar associations, but the Institute serves as the core.

In medicine, postgraduate courses are organized by medical schools as a part of their traditional obligation for the continuing education of physicians. Courses may be part-time or full-time, and may last for a day or two or for months. They usually do not lead to a degree. The organization of these teaching facilities falls into three patterns. The first and most highly organized is conducted in a postgraduate medical school. Usually these have their own deans, budgets and facilities, although regular medical school faculty members may be used by them. In the next pattern, the medical school appoints "an assistant dean in charge of" or "a director of" postgraduate medical education. This individual is responsible for organization of courses, acceptance of students, and selection of medical school faculty members to give instruction. In the third pattern, the dean and faculty of the medical school design and carry out the postgraduate educational program.

One of the most interesting features of the programs conducted by the life underwriters is the extent to which enrollment in the courses is promoted. The first enrollment drive is begun in the spring of each year for courses that will begin in the fall. This is followed up by another drive in the summer. Use is made of literature and posters, testimonials, announcements at meetings, talks before groups, letters, press releases and personal calls.

Professional societies and trade

associations exist for many reasons, only one of which may be education. The American Management Association, however, appears to have as principal purpose education and exchange of information among management personnel. It says, in fact, that it conducts "a continuous program of education by management for management." The program includes conferences, workshop seminars, orientation seminars, special conferences and educational exhibits at various points throughout the country. In addition, a five-week management course and a three-week course in executive communication are regularly conducted in New York.

Continuing education in banking proceeds in three stages: (1) practical personal training by each bank; (2) courses made available to all banking personnel by the American Institute of Banking operating as a section of the American Bankers Association, and (3) advanced graduate courses such as those offered at the Graduate School of Banking at Rutgers, and other schools of banking at the University of Wisconsin, the University of Washington, and Louisiana State University. The latter three, patterned after the school at Rutgers, offer their courses at summer sessions. A new graduate school of banking is now being established at Southern Methodist University, Dallas.

It is well to note that, in considering the continuing education of the accountant, we do not address ourselves to accounting subjects alone. It is true that the accountant must give continuing study to accounting itself to keep abreast of changes in standards, techniques, procedures and rules, to fill gaps in his experience and training, to expand his general

knowledge of accounting, and to develop knowledge in specialized fields. In addition, Donald C. Perry, in his Dickinson Lectures at Harvard Graduate School in 1955, makes an excellent point. He says that "auditing practice has become much more an the following of routine steps examination . . . (it calls) for a high order of informed judgment based on recognized general standards and on broad understanding of business organization, business methods and business relationships."

If this is the equipment required of the auditor, think of the greatly enlarged knowledge the accountant must have when he undertakes to advise business management on business problems. And business is rapidly turning to the CPA for a greater and greater range of services of this sort. Perhaps it would serve to bring my remarks into focus if I should mention one field of advanced study that accountants, as the profession of business, might pursue. The relatively new technique called "management planning and control" can serve as an example. It employs both long and short-range planning, usually in terms of accounts. Standards are decided and established for each key element of the operation, again usually in terms of accounts. Management then has its notice drawn to the features of the operation requiring attention by reports which emphasize the places where standards are not being met. These reports are usually prepared from the accounts. This method is now used by many large and well-managed companies. The method deserves, however, much wider use than it is receiving, and some of its basic elements, at least, is usable in business operations of

all sizes down to the very smallest. It is usable, further, in governmental and other nonprofit operations. There is scope here for much advanced study, experimentation, and exchange of thought and experience. The method is susceptible of much refinement over anything now known.

Events which are not entirely of our own making have presented us with a unique opportunity and a great responsibility. The importance and the urgency of the need for a comprehensive program of continuing professional education are so great, and the area is so large, as to require the best thinking and efforts of all groups, organizations, and individual members of the profession.

For instance, teachers of accounting, deans and college administrators can and, I think, should study the ways in which schools can best contribute to the postgraduate education of their graduates and others.

State societies and chapters can make an important contribution. Most programs will have to depend for their success on the interest and enthusiasm of local groups. Possibly the various chapters should start to discuss the problems of staff training and continuing education at regular chapter meetings as well as establishing committees to work out programs. Experimentation and active support of existing patterns for education are needed, but we also need new ideas and we need an increasing awareness by all members of the urgency and importance of the problem.

Accounting firms can play an important part. Recognition of the need for more training and professional education should be implemented in firm policies. Staff members should be encouraged and, where appropriate,

should be required to participate in available programs.

The American Institute of Certified Public Accountants, through its officers and committees, is beginning to become more fully aware of the need. Consideration is being given to undertaking a comprehensive study of the entire educational needs of the profession and to developing a plan for the Institute's participation in the various programs which may be developed.

Only through a bold program and a concerted attack can we overcome

the present deficiency and build the framework for the future growth and development of the profession. The best thinking and the efforts of each individual member of the profession are going to be required. Group organizations, and firms are going to act only to the degree that you as individuals participate.

Surely we have today conditions which say plainly to us that accountancy must deepen and broaden its knowledge and must create the facilities for advanced study which will enable it to do so.

PROTECTION WITH FISCAL RESPONSIBILITY

By PERCIVAL F. BRUNDAGE

It is a real pleasure for me to have the opportunity of telling you something about the Federal budget for fiscal year 1959.

Last year about this time, the Congress and the country were all for economy and this sentiment was most helpful in leading to agreement among the departments to reduce or to hold down expenditures for current programs and to eliminate many new proposals. Since September we have had tremendous pressures for more military expenditures, but this makes it even more important that the pressures for civilian economies be maintained. This was the background for the preparation of the 1959 budget, and I think that the millions of taxpayers throughout the country will make themselves heard if the proposed program does not receive full and hearty support by the Congress.

This is why I have taken as my subject the title, "Protection With Fiscal Responsibility." No one can ever complete security. That is simply not available in this life. Each individual has to run his own risk from the numerous hazards of daily living. The Federal Government can provide reasonable protection from

many of the hazards of living on this planet Earth, and, in order to do so, we must have sound economic and fiscal programs.

Let me say at the outset that I came down to Washington four years ago because I was a great admirer of the President, and I believed wholeheartedly in his goals of (1) a sound fiscal policy with efficiency in administration and balanced budgets, (2) a sound defense program with emphasis on the newest military developments along with reasonable reductions in conventional forces and weapons, (3) an end to the furious pace at which power was being concentrated in Washington, and (4) tax reductions whenever warranted by our fiscal situation.

Anyone who has not worked in Washington must find it difficult even to imagine the terrific pressures from all sides for new, larger, and better programs. Even in the middle of an economy drive these pressures come from business and professional groups as well as educators, politicians and military leaders. Last year, I said very frankly that I couldn't see any way of making drastic cuts in our huge budget total with world condi-

PERCIVAL F. BRUNDAGE served as Director of the Bureau of the Budget, Washington, D. C., until his resignation which was announced on March 13, 1958. He also is a former president of the American Institute of Certified Public Accountants. This article is adapted from an address delivered by Mr. Brundage before the Executives' Club of Chicago on January 24, 1958.

tions what they were. The very best we could do was to try to hold Federal expenditures at about the current level and prevent them from continuing to pyramid upwards.

We are proposing to exercise strict expenditure controls over all civilian programs, but our military expenditures will be rising as a result of new developments and the acceleration of timetables in recognition of the Soviet accomplishments last fall. It is interesting to observe that the Soviet leaders seem to be rather appalled at their own success in accelerating the tempo of our defense programs. Practically every step towards greater unity of the free West since World War II was the direct result of some aggressive action or attitude of the Soviet authorities.

I'm not going into an extended discussion of the Soviets' achievements versus our own, but let me say this: We have been working along similar lines in many different fields. Over 50 percent of all of our scientists and engineers have been working on government projects for basic or applied research, either directly or through contractors. Long-range ballistic missiles have had Number One top priority for more than two years. But a monopolistic dictatorship can direct pressure into specific areas more quickly and effectively than our democracy where everyone thinks for himself, has strong individual convictions, and doesn't hesitate to express them. We have to face not only the competition and differing viewpoints between the services, but also between the various contractors on government projects and even the scientists working on the same project. The testimony before congressional committees in recent months has indicated how deeply the various experts in

military and scientific matters differ as to technological details, priorities and every other aspect of our defense program. That would, of course, be impossible in Russia, but we have other advantages in our free enterprise system that far outweigh these factors. However much opinions may vary, we must be willing to accept the judgment of those at the top who make the decisions.

It is not only since the sputnik went up that the President has been concerned with the Soviet challenge. He has mentioned it emphatically every year since 1953. In spite of considerable opposition in Congress and elsewhere, he has been stressing the need for new weapons, new techniques, new strategy. And we have accomplished much in the last five years.

For example, the total expenditure for missile research, development and procurement, for construction of missile sites, and for guided missile ships will be \$5.3 billion in 1959, compared with \$4.3 billion in 1958, \$3 billion in 1957, \$1.7 billion in 1956, and \$1.1 billion in 1955.

The longer range ballistic missiles—Atlas, Titan, Thor, Jupiter, Polaris—only one of which was beyond the technical study stage two and one-half years ago—will account for nearly half of the missile procurement program for 1959. In 1953, only \$1 million was spent on these missiles. By 1957, \$1 billion was spent—one thousand times as much. In 1959, a still greater expansion is contemplated in the swiftly progressing programs for intercontinental and intermediate range ballistic missiles.

In 1953, missiles took less than two cents of each dollar spent for major procurement items; in 1957, missiles took about 15 cents of every procur-

nt dollar; and in 1959 they will
e about 24 cents.

n addition to increased govern-
nt expenditures, there has been a
ft in emphasis, which is illustrated
the fact that 75 percent of the total
nds for procurement in the 1959
dget and the 1958 supplemental
quest is programmed for new types
equipment which had not been
veloped or were still in an experi-
ntal stage only five years ago.

With all the new developments
ning along so fast, it is exceedingly
portant that we do not overorder
any one stage or the product will
obsolete by the time the last item
nes off the assembly line.

We are overwhelmingly strong in
r defensive and deterrent forces at
e present time, and we must not be
mpeded by the various newspapers
d pressure groups to go so heavily
o any one development that we
ore the many other possibilities
it may prove to be even more im-
rtant in the years ahead. I know
m personal experience how each
imant for funds is convinced that
own particular program or prod-
is of the most critical importance
d is never satisfied with the amount
ropriated, however large it may

It is interesting to see how the
merican people seem to accept and
en welcome the demand for self-
sacrifice. They are quite prepared to
spond to an appeal for "blood,
eat, and tears" to catch up with
e Russians and to surpass them. In
et, this seems easier to do than what
really necessary, namely to give up
ne local programs and desires, to
se ranks with our allies, to prac-
e tolerance, to develop greater un-
rstanding of the other peoples of

the world, and to use sound well-
balanced judgment.

The Soviet is a huge monopoly as
well as a dictatorship and, as such,
is a very dangerous competition in the
economic as well as military field. In
order to combat it, we must encourage
trade with our allies and other free
countries. We must accept their prod-
ucts to help to strengthen their econo-
mies and to maintain our own exports.
I firmly believe that the battle with
the Soviet Union on the economic
front is going to be more serious than
any battle we will be called upon to
wage in the military field.

A couple of years ago, some esti-
mates announced at congressional
hearings credited the Soviets with the
capability of producing long-range
bombers which would vastly surpass
us in numbers by 1960. We are now
told that they did not go ahead with
anything like the production sched-
ules which these estimates forecast.
Today we are told that the Soviets are
going into large scale production of
IRBM's and other missiles. I think it
is just as likely, or perhaps even more
likely, that they are producing planes
for export, generators, heavy machin-
ery of all kinds, automobiles and other
consumer durables like sewing ma-
chines to capture the markets of the
less developed nations. We must keep
our shirts on, and use good old com-
mon sense in planning our military
programs.

With the development of the St.
Lawrence Seaway, when Chicago be-
comes an ocean port, you will become
increasingly aware of the importance
of foreign trade. As well as benefiting
our exports, this is the most likely
means of stimulating an exchange of
ideas and opening up of other coun-
tries, including those behind the Iron
Curtain, to Western developments.

Without a tremendous increase in world trade, in my opinion, we will never achieve any extended peace or important improvements in the lot of the peoples of the world. We cannot keep our own standard of living at a level which is many times above that of much of the rest of the world. We must help to raise their level or we will find ours is sinking. This is to our own self-interest, our enlightened self-interest, as the President calls it. The reciprocal trade program should be renewed for a period of at least 5 years so that the uncertainty as to our position will not be troubling our allies again within a couple of years. It is particularly important that we be in a position to make commitments when the European Economic Community (often called the European Common Market) comes into effect, or we will find ourselves shut out of this tremendous market for our products.

Before leaving the military and foreign programs, I would like to refer to the reorganization proposals outlined for the Department of Defense and the services in the President's State of the Union Message. He feels very strongly, as he did ten years ago, that a considerable improvement can be made with greater efficiency, substantial economies and, above all, more effective operations. The President stated:

"A major purpose of military organization is to achieve real unity in the Defense Establishment in all the principal features of military activity. Of all these, one of the most important to our Nation's security is strategic planning and control. This work must be done under unified direction.

"The defense structure must be one which, as a whole, can assume, with top efficiency and without friction, the defense of America. The Defense

Establishment must therefore plan for a better integration of its defensive resources, particularly with respect to the newer weapons now being and under development. These obviously require full coordination in their development, production, and use. Good organization can help assure this coordination.

"In recognition of the need for single control in some of our most advanced development projects, the Secretary of Defense has already decided to concentrate into one organization all the anti-missile and satellite technology undertaken within the Department of Defense.

"Another requirement of military organization is a clear subordination of the military services to duly constituted civilian authority. This control must be real; not merely on the surface.

"Next there must be assurance that an excessive number of compartment in an organization will not create costly and confusing compartments in our scientific and industrial effort.

"Finally, to end interservice disputes requires clear organization and decisive central direction, supported by the unstinted cooperation of every individual in the Defense Establishment, civilian and military."

Turning to our domestic civilian programs, I am sure that, after studying you will be satisfied that the 1955 budget provides well-rounded adequate Federal services to cover all segments of the economy. But there will require, as the President said in his State of the Union Message, sacrifice and the willingness to accept the elimination of unneeded facilities and reductions in some desirable programs that are strongly supported by local interests.

While each of these proposals w

doubtedly receive criticism and opposition from some segment of our population, they do fit into an overall picture which I believe should and will receive the country's support. They are realistic proposals to meet the desperate need for fiscal control over our ever-mounting benefit programs. In view of their importance I shall summarize some of our proposals.

PROPOSALS TO INCREASE RECEIPTS

User charges. In the budget message, the President indicated his belief that when the Government provides a service conferring a special quasi-commercial benefit on identifiable individuals or groups above and beyond the benefits to the public generally, it should charge the beneficiaries for the special service, rather than place the full burden of the cost on the general taxpayer. Accordingly, I made several proposals in the field of "user charges."

1. *Postal Service.* In every year since the close of World War II the postal service has incurred large deficits which have placed heavy and undue burdens on taxpayers to the advantage of large users of the mails. In view of present and prospective postal deficits, legislation to authorize adequate postal rates has become one of the most urgent items of unfinished business before the Congress. To provide revenues, which will more adequately meet present needs, the President proposes that the postal legislation now pending before the Congress be amended, primarily by establishing a 1-cent letter rate on all except local letters. This increase over last year's recommendation is needed to cover part of the cost of the pay increase and other rising costs. The recommended increase should result in an

addition of \$700 million to postal revenues in the fiscal year 1959. With the postal pay adjustment we are recommending there will still be a postal deficit of approximately \$144 million.

2. *Aviation.* The Federal Government provides a wide range of special services benefiting private users of the airspace. It is increasingly appropriate that these users pay their fair share of the costs. The cost of new facilities alone will total \$1 billion over the next few years and annual operating costs to the Federal Government of \$200 million at present are likely to be doubled in 5 years. As first steps toward this end, it is proposed that a tax of 3½ cents a gallon be levied on jet fuels and that taxes on aviation gasoline be increased to 3½ cents a gallon from the present 2 cents, with increases of ¾ cent per year for 4 years in both taxes up to 6½ cents a gallon. The receipts from taxes on aviation gasoline, which now go into highway trust fund (3 cents per gallon of which 1 cent is later refunded), should be kept in the general revenues to help finance the operations of the airways.

3. *Other.* The budget message also recommended that legislation be enacted to raise patent fees, and to charge employers of longshoremen for the cost of administering disability compensation.

In addition, all Government agencies have recently been instructed to prepare legislative proposals generally designed to remove present restrictions or limitations on their authority (1) to recover full cost to the Government of services that provide special benefits to individuals or groups and (2) to obtain a fair market value for the use or sale of federally owned resources or property. These proposals will cover all areas in

which existing legislation prohibits charges or fees, and areas in which existing legislation is silent on the subject of charges but where the agency considers an expression of congressional policy desirable prior to initiating charges. Examples of areas of government activity which are being considered are licensing; use of water navigation aids and facilities; publications; maps and navigation charts; recreation and tourist facilities; grazing; oil, gas, and mineral leasing; and mining claims.

Interest rates. Another important change, which is part of the general user charge considerations, is the need for adjusting interest rates in Federal credit programs.

The President is recommending the enactment of legislation which would permit greater flexibility for the Government in setting interest rates on loans it makes in the future, and which would require that, insofar as consistent with the purposes of each program, all of the costs involved be paid by the borrowers. Such legislation, by removing or reducing hidden subsidies, would make a significant contribution toward better fiscal management. It would also produce some added income.

Moreover, for loan guaranty programs, the Government should be authorized to permit interest rates high enough to attract private lenders. It is suggested that all statutory limitations or ceilings placed on interest rates be reviewed, and that authority be provided to vary the rates for guaranteed or insured loans in line with market conditions and under proper safeguards.

Programs affected by the recommendations on interest rates include the following:

1. College housing loans. Private

financing of college housing should be encouraged by (1) replacing the subsidized interest rates required by the present statutes with rates no less than the Government's cost, (2) authorizing Federal guaranties of college housing obligations which do not have Federal tax exemption, and (3) prohibiting direct loans where private funds are available on reasonable terms.

2. Special assistance mortgage purchases, such as for armed services and cooperative housing. Repeal of the statutory requirement that all purchases by the Federal National Mortgage Association be made at par and authority for increases in interest rates on several types of mortgages will encourage private financing and reduce future reliance on the Federal assistance. Action on these recommendations would stimulate the building industry and provide more homes during 1958.

3. Rural electrification and telephone loans. The electrification program was authorized in 1936 and has covered 95% of the farms in the country for electrification and telephone loans. Today's demands are largely for heavying up the lines and for power generation, about 50 percent of which is for industrial plants and nonfarm residential use. The source of capital available to the Rural Electrification Administration system would be broadened by legislation (1) to assist both electric and telephone borrowers to obtain financing from private sources where the security is adequate and the loans can be repaid within a reasonable time, and (2) to adjust interest rates on future loans to meet the Government's costs. The present statutory rate is an unfair charge against the general taxpayer.

PROPOSALS TO REDUCE EXPENDITURES

On the expenditure side, adjustments are proposed in various programs which will result in savings in future years after a suitable time for extending State and local budget procedures has been allowed and after notice to affected individuals.

A. First, there are programs where shifting emphasis or changing needs present future requirements for specific types of Federal assistance.

1. *Agriculture conservation program.* The budget recommends that program level of \$125 million be authorized for the 1959 crop year, one-half the amount authorized for the 1958 program. Those practices which are a part of usual and required annual farming methods or which return immediate benefits to the farm are properly the responsibility of the farmer, rather than of the Government.

2. *Grants for hospital construction.* This program was authorized in 1947 and has met the most urgent postwar shortages. Appropriations totaling \$2.2 billion are estimated through the fiscal year 1959. The Federal program could now be modified to meet only the most urgent situations with emphasis on specialized hospitals.

3. *Veteran's pensions.* Expenditures for this purpose increased from \$83 million in the fiscal year 1956 to \$151 million in 1957. Further increases are anticipated in 1958 and 1959 to \$1,046 million and \$1,142 million, respectively. Nearly one-half of our citizens are veterans and their families and dependents. Over the years we have seen a growth in general public benefit and welfare programs which are now available to veterans as well as to other groups of the population. Veterans' pensions cover needs not related to the veteran's period of

service, but rather to the general hazards faced by all people—health and income. A message on veterans' affairs will be transmitted to the Congress with some of the recommendations contained in the Bradley Commission Report, which would enable us to discharge our national responsibilities to veterans with the greatest possible equity to all concerned.

B. Second, there are programs where the administration proposes an increase in State and local participation and a decrease in the Federal proportion, but with no reduction in the total combined outlay.

In two cases recommended by the Joint Federal-State Action Committee, grants for construction of waste treatment facilities and vocational education, it is proposed that the Federal share be eliminated beginning in the fiscal year 1960, with accompanying revenue adjustments.

In four other cases, it is proposed that the Federal proportion gradually be reduced.

1. *Public assistance grants.* Expenditures for these grants on an accrual basis are estimated to increase from \$1,462 million in 1956 to an estimated \$1,824 million in 1959. During this period the Federal share of the total will have increased from 54 percent to 55.7 percent. It is proposed that the Federal share be gradually reduced to 50 percent.

2. *Urban renewal.* The urban renewal program is well under way throughout the nation and the states and local communities should assume a share of the administrative responsibilities and financial costs more nearly commensurate with the benefits which their citizens receive. The budget recommends that in the future the local communities should share in the costs of planning from the start. In addi-

tion, the present formula under which the local agency pays for one-third and Federal capital grants pay for the remaining two-thirds of the net project cost should be changed by providing for annual reductions, so that by the fiscal year 1962 the Federal Government would contribute not more than 50 percent of the cost of local projects.

3. *Grants for schools in federally-affected areas.* We are suggesting that Federal payments be limited to cover the children of families living and working on Federal property. Expenditures for construction, and for maintenance and operation of schools under this program are estimated to be \$212 million in 1959.

4. *Natural disaster relief.* The Governors of the Federal-State Action Committee have agreed to recommend that the States absorb annual losses up to fixed amounts.

C. Next we have programs where proposals are designed to free the agricultural economy from excessive controls.

1. *Greater flexibility in agricultural price supports.* Expenditures for Commodity Credit Corporation price support operations (net) are estimated to be \$2.4 billion in 1959. The President has sent a special message to the Congress recommending changes in existing legislation so that the Secretary of Agriculture will be authorized to establish price supports for basic crops consistent with the increased productive capacity of our agriculture.

The agricultural revolution of the last ten years has been as significant as the industrial revolution of a century ago. The laws enacted to protect farmers are actually benefiting mostly the large commercial farms, and price supports under these laws have interfered with expansion of our markets.

Farmers and the nation as a whole would actually be better off with greater freedom from restrictions and with prices and output determined under free enterprise. Federal assistance should then be confined to promoting adjustments in agriculture and aiding the needy farmer.

An analysis of price support and stabilization costs under existing law for the past fiscal year indicates that farms having sales of under \$2,500 annually, which comprise 56 percent of all farms, accounted for less than 1 percent of such costs, while farms having sales over \$5,000, which comprise 25 percent of all farms, accounted for 79 percent of such costs.

You may have read about the farmer in California and Arizona who paid Uncle Sam a penalty of \$965,000 last year for growing 4,600 acres of cotton beyond his allotment. He believes, as do many other farmers, large and small, that they would be better off with controls and price maintenance.

2. *Soil bank acreage reserve.* The acreage reserve was authorized in 1956 and expenditures are estimated to be \$405 million in the fiscal year 1959. It is proposed in the budget to terminate the acreage reserve at the end of the 1958 crop year. A partial offsetting increase of \$125 million is recommended in the soil bank conservation reserve program for the 1959 calendar year since more material and lasting benefits are obtained, per dollar spent, from this part of the soil bank.

D. Another recommendation which should hold down budget totals is that no new projects be started in the fiscal year 1959 for construction of water resource projects by the Corps of Engineers and the Bureau of Reclamation, in view of the high level of current spending resulting from the large

number of new projects started during the last three years. This has already raised vociferous protests, although with the large number of new starts authorized by Congress during the last three years the level of expenditures by 1960, even without any new starts in 1959, will approach \$1 billion.

E. Finally, certain previously recommended legislation is not being requested in the fiscal year 1959. Examples are general aid for school construction, major medical care insurance for Federal employees, and certain other grant programs.

As a matter of fact, the state governors in the meetings of the Joint Action Committee, to which I have referred, have indicated their strong conviction that the localities and the states want to be, and must be, responsible for the education of their children. I think we must all admit that over the last 20 years so-called progressive education has been overemphasized. I know from my own experience. We were told not to discipline our children, but to let the little flowers unfold in any direction that they desired in order to develop their individuality. I feel that we have had too little work and too little discipline and that we may have to go back to required Latin grammar and algebra, which are both good mental training. We should also have considerably higher requirements for admission to college. This doesn't require Federal funds and I have great confidence that when the State education departments, the Parent-Teachers' Associations throughout the country, and the educators and pupils themselves understand the problem they will tackle it sensibly and will do better than by seeking help from Washington. Our recommendations for education this

year are to serve as a stimulus for a short period only.

BUDGET REVIEW

Before closing I am going to give you a very brief review of the whole budget picture for the current fiscal year as well as 1959. As the result of the decrease in business activity during the last quarter of the calendar year 1957, the estimate of fiscal year 1958 receipts of \$73.6 billion made a year ago January and \$73.5 billion in October has now been reduced to \$72.4 billion. This is a decrease of \$1.2 billion from the original estimate. At the same time, increased defense spending to accelerate missile procurement, for research, basic and applied, for increased SAC dispersal, and for atomic ships has added \$.9 billion to our expenditures. There are other changes up and down, but either of these two principal changes alone would not have thrown us into the red. However, both together have changed our estimate of a \$1.6 billion surplus into a \$.4 billion budget deficit. The consolidated cash statement still shows a slight surplus, and I hope that by June 30 we may be able to get back into the black for fiscal year 1958, in the conventional budget.

For 1959, our experts in the Treasury, Council of Economic Advisers, and others consulted have agreed on an estimated income figure of \$74.4 billion in the firm belief that the expansion of our economy will soon be resumed.

Total new obligational authority recommended for the fiscal year 1959 amounts to \$72.5 billion. In addition, \$6.6 billion of supplemental authorizations are estimated for the current year, primarily for the Department of Defense, \$1.3 billion, the Commodity Credit Corporation, \$2.3 billion to make up previous losses, and

the Export-Import Bank, \$2.0 billion.

Estimated budget expenditures for the fiscal year 1959 are \$73.9 billion. Included in the estimated 1959 expenditures is \$1.1 billion as an allowance for proposed legislation and contingencies. Five hundred million dollars of this is specifically for defense contingencies, \$339 million is estimated for proposed pay adjustments for postal and other civilian employees not in the Department of Defense, and \$300 million for other contingencies. The cost of the proposed pay adjustments for military and civilian personnel of the Department of Defense is included in the estimates for that Department. Including the Department of Defense, the budget provides \$1.1 billion of estimated 1959 expenditures for proposed pay adjustments for both military and civilian personnel, which is expected to be largely offset through greater efficiency and smaller staffs. In fact, Ralph Cordiner firmly believes it will save us billions of dollars within a few years.

CONCLUSION

In conclusion, I have been strongly impressed with the difficulty of combating Parkinson's law. I assume you have seen the recent booklet announcing the discoveries of Professor Parkinson that: (1) a bureaucratic official wants to multiply subordinates, not rivals; and (2) officials make work for each other. Whenever a civil servant finds himself overworked, Dr. Parkinson says, whether real or imaginary is immaterial, he immediately asks for two assistants. By dividing the work into two categories he will be the only one who comprehends both and he will not have an immediate successor avail-

able. Dr. Parkinson comes to the conclusion that, regardless of the increase of work, bureaucracy increases its administrative personnel at an average rate of 5.6 percent per annum.

If you will look at our statistics you will find that while we have not been able to cut our number of employees materially in the last five years, we have demonstrated that Parkinson's Law can be defeated. I hope that your further study of our 1959 budget will lead you to believe with me that we have done our best. It is a well-balanced, sound budget which sets forth programs which adequately meet the responsibilities of the Federal Government in all areas.

Our revenues should be adequate to cover expenditures and permit debt reduction during periods of high business activity and reductions of taxes when possible. In view of the increases needed in our defense expenditures imposed on us by world conditions, general tax reductions would not be wise at the present time. If, as, and when we can reach some satisfactory agreement with the Soviet Union containing significant steps toward disarmament which are accompanied by inspection to assure compliance, then we can consider tax-reductions and savings that would be worthwhile.

Meanwhile, with the full cooperation and support of the Congress and the public, I believe that we can advance the principles in which we believe and which have guided us in preparing the budget—economy in expenditures, efficiency in operations, promotion of growth and stability in a free enterprise economy, a vigorous Federal-State system, concern for human well-being, and priority of national security over lesser needs.

Public Relations for Certified Public Accountants

By JEANNETTE M. COCHRANE

There is a widespread illusion among business concerns and professional associations that good public relations can be bought. Put another way, many people feel that, if their organization would only hire a press agent, its public relations problems would be over.

That better public relations for CPAs is uppermost in the minds of Illinois Society members was quite evident in a questionnaire survey that was made several years ago. But, what escapes many of us from time to time is the real meaning of the term "public relations"—namely, "earned and merited recognition."

No organization, whether it be a business corporation or a professional society, can acquire and retain the goodwill of the public unless it *earns* its reputation. This means that, first of all, it must do a good job. It must make a sound, quality product and give good customer service. Or, in the case of the Illinois Society, its members must render thorough, competent, professional service to their clients. Like a taffy apple that is wormy inside, no amount of press agency can long cover up an inferior product or service.

There is a second general requisite

for good public relations that is equally important. Assuming that we as CPAs do a good job for our clients, this still is not enough to earn for ourselves that measure of respect and goodwill of the general public which we would all like to have. Today's corporation or association must also identify its interest with that of the public.

One of the ways this can be done is through public service. And this is something that cannot be delegated to a paid employee. It is a responsibility to our profession that each of us must shoulder.

Is the public service record of CPAs one that we can be proud of—one that merits public approbation?

In April, 1956, a questionnaire went out asking for information on the public service activities of individual members of the Illinois Society. Of the 2500 questionnaires mailed, 700 were returned—a 28% response. Of those who responded, 451 or 72% reported that they were involved in some type of outside service activity. Of those who responded, 50% devoted time to church work; 45% cited service in social clubs, youth and other service groups; and 35% mentioned charity work.

JEANNETTE M. COCHRANE is Executive Director of the Illinois Society of Certified Public Accountants. This article was written as a result of continuing discussions by the Society's Committee on Public Service and Information concerning the nature and importance of the complementary concepts of professional public service and professional public relations.

The average member reporting public service spent 186 hours a year, approximately fifteen hours a month, at it in 1955. The most common type of service was as a treasurer, auditor, board member, or fund raiser. The overall average time spent per activity was 106 hours per year.

On the surface, this record appears commendable. However, it does not reflect any considerable portion of the Society's membership as a whole, just 28%. We suspect that the public service record of the 72% who did not respond to the questionnaire might not present as good a picture. In the second place, the averages are inflated because of the prodigious amount of outside service by a handful of members. Twenty-seven members spent over 500 hours per year, with two

reporting over 1000 hours a year in church work alone. Our hats are off to members who are giving of themselves and are doing a public relations job for the profession.

It is simply human nature to respect, like, and do business with those people who go out of their way to serve their fellow men. Not only is individual public service good public relations for our profession, but it is also the surest way we know of to wipe out the old "green eyeshade" stereotype image of the introverted CPA.

We hope that another public service survey can be taken soon and that the results will provide potent publicity ammunition in the growing public relations program of our Society.

TAX COMMENTS

Conducted by the Committee on Taxation of the
Illinois Society of Certified Public Accountants

WHY THE CONSOLIDATED RETURN?

Section 1501 of the 1954 Internal Revenue Code is entitled "Privilege to File Consolidated Returns." The word "privilege" implies a right to a special benefit. For the exercise of this special benefit the Code exacts its penalty. The only justifiable basis for electing to file a consolidated return is immediate tax saving of consequence.

There is a misconception among some that tax planning in this area is limited to big business. Experience has proven, to the contrary, that sizeable tax benefits have been achieved, not only by big business, but by small and medium sized companies. In this day of expansion, diversification, and merging of business interests, the affiliated group is common in businesses of all sizes.

Were a company to expand strictly and solely within its own corporate structure, no consolidated return considerations would ever occur. The expanding company, however, will often find it difficult for business reasons to stay within its own corporate structure. Management often prefers to incorporate separately unlike business activities for purposes of control, for bonus computations, local income tax requirements, and for confining minority interests to their own incorporated company. Once the parent and

subsidiary relationship with at least 80% voting control exists, the entire subject of the consolidated return comes into focus.

The area of taxation embraced in the consolidated return is so closely tied to accounting concepts of income that it is a field in which the accountant is indispensable.

The consolidated return has advantages:

- (1) Losses of the subsidiary may be deducted from profits of the parent and other members of the affiliate group;
- (2) Inter-company profits are not taxed;
- (3) Inter-company dividends are not taxed;
- (4) Capital gains of one corporation may be offset by capital losses of another corporation;
- (5) Extreme refinements of accounting relating to distribution of income and expenses among the various members of the affiliated group may not be required.

The consolidated return has disadvantages:

- (1) There is a 2% penalty added to the tax from the first dollar of income;
- (2) There is only one \$25,000.00 surtax exemption;
- (3) It may be necessary to change accounting periods and accounting methods;
- (4) All members of the affiliated group must consent to the Regulations of the Commissioner and thus give him, through his Regulations, the right to

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establish law rather than to interpret law.

- (5) Once having filed a consolidated return an affiliated group must continue to file consolidated returns unless certain conditions are met.

Given the choice, consolidated returns in most instances should not be filed unless distinct advantages accrue immediately.

The code deals with consolidated returns in Chapter 6; it is brevity carried to the extreme. The Law leaves it to the Regulations for extensive instructions designed to correctly establish taxable income and to prevent abuse of the privilege which, because of the very complexity of the subject, might otherwise result. In order to present the application of the Regulations in action, there is submitted a series of circumstances, not uncommon, and the development of possible solutions, with comments. A brief statement of the problem and the solution by years appears in tabular form at the conclusion of this paper.

AN AFFILIATION IS ESTABLISHED

Company A is a successful furniture manufacturer with an excess of productive capacity. On January 1, 1954 it is ready to establish and open a retail furniture store in another State, where it will sell its manufactured product.

Our corporation may operate the separate business as a branch of its own company. This method has several disadvantages: (1) Profits of the branch will be added to the high profit of the manufacturing plant and will be taxed at a 52% rate. (2) Profits of the branch may aggravate a presently dangerous situation with respect to unreasonable accumulation of surplus under *Sec. 535*. (3). If the activities are to be carried on in areas subject to local income tax laws, there will be

problems of apportionment of income subject to each of the two tax laws.

Corporation A may permit its stockholders to organize a separate corporation to operate the selling business. Objection may be raised on the basis that, should losses be sustained by the new corporation, these losses will not be deductible by the successful manufacturing corporation.

It appears quite attractive to Corporation A to organize the new business as a wholly-owned subsidiary: (1) The subsidiary will have its own surtax exemption, producing a savings of \$5,500.00 on the first \$25,000.00 of income. (2) The subsidiary will have its own \$60,000.00 minimum credit for surplus accumulations under *Sec. 535 (c) (2)*. (3) Should there be losses in one of the two companies, they may both elect to file a consolidated return to produce a net taxable income. (4) At some future date, after the subsidiary is firmly established the corporation may be spun off to the parent's shareholders.

Corporation A decides to form a wholly-owned subsidiary, Corporation B, to operate its retail sales outlet. Having at least 80% of the total voting power and at least 80% of all other non-voting stock there is a parent-subsidiary relationship as an affiliated group in accordance with *Sec. 1504* of the Code. Obviously, Corporation A intends that Corporation B shall be profitable and, by filing a separate return, to retain its own \$25,000.00 surtax exemption. If Corporation B is organized by a transfer of assets from A it will fall directly into the trap of *Sec. 1551*, and will have neither its own separate \$25,000.00 surtax exemption nor its own \$60,000.00 credit for surplus accumulation, unless it can establish by the "clear preponderance of the evi-

dence" that tax savings was not the primary motive. On the other hand, if Corporation A organizes B as a separate corporate entity and, by transfer of cash, buys B's capital shares, both the \$25,000.00 surtax exemption and the \$60,000.00 surplus accumulation credit will be retained. The two entities must be operated as separate corporations, and every care should be undertaken to avoid an arbitrary shift of profits from one to the other. If accurate accounting is not made for each of these corporations the Commissioner may attempt to tax both corporations as a single unit under *Sec. 482*, or reallocate income and deductions among the corporations.

The danger of separate incorporation is illustrated in the case of *Coastal Oil Storage Company—CA 4-3/11/57 (CCH Par. 9518—U.S. Tax Cases)* which holds that *Section 269* may cause disallowance of the surtax exemption in the case of a newly formed corporation where the *principal* purpose was to obtain tax benefits, notwithstanding that there were *other business purposes*. Here the taxpayer, by transfer of property, formed a separate corporation for the purpose of performing Government contracts, thus to distinguish this business from its regular business; and it was held that while there might be a sound business purpose for separate incorporation, the taxpayer failed to prove that tax benefits were not the *major* purpose of the separate incorporation.

THE FIRST YEAR OF OPERATIONS (1954)

Parent A—net income	\$100,000.00
Subsidiary B—net loss	(75,000.00)

If A and B file separate returns, A will be taxed on its profits and B's

loss will not reduce the tax for that year. By filing a consolidated return B's loss may be offset against A's income and the tax will be computed on the combined net income of \$25,000.00. The parent, Corporation A, decides to file a consolidated return. It will act as the agent for the affiliated group, the fiscal years of both companies will end on the same date, and it will include in its consolidated return a consent on Form 1122 to an irrevocable determination of income on a consolidated basis and to agreement to the regulations of the Commissioner. Once having filed the consolidated return, A and B must continue to do so unless certain specified conditions are met.

THE SECOND YEAR OF OPERATIONS (1955)

Parent A—net income	\$200,000.00
Subsidiary B—net income	25,000.00

Herein lies the disadvantage of the consolidated return. Once having filed the consolidated return the affiliated group must continue to do so unless there is a change in the income tax law which would render the filing of the consolidated returns of corporations *as a class* undesirable, in which event the Commissioner may grant the right of a new election. In 1955, the Commissioner did not authorize an election to change from the consolidated to the separate return basis. Corporation A and B may request that the Commissioner permit a change, but in all probability the request would be denied. In effect, the affiliated group is frozen to its prior election, and it must compute its tax on \$225,000.00 at the 32% and 54% rates.

The management is now seriously concerned with the future of its consolidated tax structure. All the evi-

dence points to profitable operations for both companies. B has ceased providing its separate surtax exemption, and in fact causes A and itself a penalty tax of 2%. How can the consolidated return requirement be broken?

THE PARENT BREAKS THE CONSOLIDATED RETURN REQUIREMENT (1956)

Corporation A is now ready to seek a new outlet for its increased production. It may organize a second subsidiary which will have its own surtax exemption and its own surplus accumulation credit, but only if A and B file separate returns. The Regulations deny the right of a new election if Corporation A brings into the consolidated group a new corporation which it establishes. However, if the stock of an existing corporation is purchased and a new corporation is added to the affiliation, the right to a new election may thus be established (*Regulations 1.1502-11(a)(1).*) The addition must be a bona fide acquisition and must have a business purpose other than a proposed saving in taxes. A proceeds to buy 100% of the capital shares of Corporation C which for many years has operated a retail furniture store. C is a loss corporation with carryover losses of \$100,000.00. At this point, A would like to break its consolidated return requirement, to achieve separate surtax exemptions for B and C, and to preserve and use the loss carryover of C. Particular attention must now be directed to *Sec. 269* of the Code which provides a rule of disproportionate purchase price as evidencing a tax avoidance purpose on the acquisition of loss corporations, wherein the Commissioner seeks to deny the loss carryover and the other

tax benefits where the principal purpose of the acquisition was tax reduction by securing benefits not otherwise available. Assuming that A can establish the principal purpose as a sound business purpose not subject to the provisions of *Sec. 269*, it must now go to *Sec. 382* which provides that the loss carryover will not be permitted unless Corporation C will continue essentially in the same business and in the same location. Corporation A will operate in such manner as to avoid all the objectionable practices in *Sec. 382(a)(1)(c)*, and accordingly will continue to conduct C's business unchanged from its business prior to the affiliation.

At the end of the year 1956,

Parent A—net income	\$300,000.00
Subsidiary B—net income	100,000.00
Subsidiary C—net loss	(10,000.00)

The consolidated return requirement is now broken, and all three corporations have the right to a new election. They will file separate returns. Although C's loss is not deductible in separate returns for 1956, and gives no tax reduction to A and B, there would be no advantage to filing a consolidated return because of objections inherent in this method of reporting.

IN 1957 PARENT A SUFFERS SERIOUS LOSSES RESULTING FROM A LABOR STRIKE IN ITS MANUFACTURING PLANT

The results for the year 1957 show the following:

Parent A—net loss	(\$400,000.00)
Subsidiary B—net income	200,000.00
Subsidiary C—net income	75,000.00

The affiliated group may elect to file consolidated returns during any year without permission from the Commissioner. If it files separate re-

turns, A would carry back its \$400,000.00 loss to 1955 and 1956 and obtain a refund of taxes paid for those years; B would pay a tax on \$200,000.00, and C would file a loss return (by offsetting its 1957 income of \$75,000.00 against its unused losses of \$100,000.00 carried forward from the year prior to affiliation and \$10,000.00 loss suffered in 1956, which loss was not used because a consolidated return was not filed in 1956). Our corporation A decides to file a consolidated return and thus avoid the tax B would have had to pay in a separate return. A will file a claim for refund carrying back its \$200,000.00 consolidated loss against A's 1955 consolidated income. The consolidated group may use the benefit of C's carry-over losses to the extent of \$75,000.00 during years prior to affiliation, and it will continue to have an unused loss carry-over of \$35,000.00 which may be used to offset future income earned by C, but not by any other member of the affiliate group. This example illustrates the requirement that losses suffered prior to affiliation may be used to offset income earned only by the same corporation, and losses suffered prior to affiliation may not be used to offset income of any other corporation in the affiliated group.

THE PARENT LIQUIDATES ONE OF ITS SUBSIDIARIES

A discussion of the parent-subsidiary relationship would not be complete without a reference to the problems of subsidiary dissolutions.

The complete liquidation of a subsidiary generally may be accomplished without gain or loss under *Sec. 332*. If the stock of the subsidiary were held for less than two years, the presumption is that the stock was pur-

chased to obtain the subsidiary's assets, and its cost basis of the stock will be allocated to the assets received on dissolution (*Sec. 334 (b) (2) (B)*). If the subsidiary's stock had been held for more than two years, the cost basis of the assets received on dissolution will be the same as the basis in the hands of the subsidiary (*Sec. 334 (b) (1)*).

Since the parent generally has the opportunity to plan the timing of a dissolution of a subsidiary, it has these two alternatives, each of which may be desirable under given circumstances:

- (1) Dissolve the subsidiary *within* two years after purchase of the stock. It will then use the cost basis of its stock as the basis of the assets received on dissolution [*Sec. 334 (b) (2) (B)*]. This makes sense where it paid a premium for the stock of the subsidiary, but it will lose the benefit of any unused loss carry-over of the subsidiary (*Sec. 381*).
- (2) Dissolve the subsidiary *after* two years from the date of purchase of the stock. It will then use the cost basis of the assets to the subsidiary (*Sec. 334 (b) (1)*). This makes sense where it made a bargain purchase of the stock, as it will obtain a stepped-up basis for the subsidiary's assets (for depreciation and for cost in the event of sale). It will also retain the unused loss carry-overs of the subsidiary (*Sec. 332*).

Reference has been made to the cost basis of the subsidiary's stock in the hands of the parent. This can be an involved computation, and the cost basis may not be the same as it appears on the books of the parent. The cost basis of the investment in the subsidiary must be reduced by the subsidiary's losses during consolidated return years which could not have been used by the subsidiary as carry-backs or carryovers had it filed separate returns for each year. The purpose of this computation is to prevent losses from being deducted twice

—once in a consolidated return, and again when the stock is sold or the subsidiary liquidated.

In a tax-free liquidation under *Sec. 332*, the unused losses of the subsidiary during the period of affiliation may be deducted by the parent in the year of liquidation, provided that the basis of the assets received on dissolution by the parent will be the same as in the hands of the subsidiary (*Sec. 381 (a) (1)*). There is a specific provision that a liquidation where there is a changed basis of the assets, as under a *Sec. 334 (b) (2) (B)* liquidation, will result in the loss of unused carry-over losses and the losses will not be transmitted to the parent (*Sec. 381 (a) (1)*). Here again, complexity is the rule, and the simple statement that the parent may deduct the unused losses of the subsidiary on dissolution is governed by a series of rules providing a limitation in the year of dissolution; these lengthy rules are set out as clearly as can be expected in the *Senate Committee Report on Sec. 381*.

CONCLUSION AND COMMENTS

Given the choice, consolidated returns should not be filed unless immediate advantages accrue. In separate returns each corporation has its own surtax exemption; in a consolidated return there is only one surtax exemption. When some members of the affiliated group have current year's losses, these losses will offset income of the remaining members in a consolidated return. If a loss corporation in an affiliated group expects to earn income within five succeeding years of an amount equal or more than its loss carry-forward, the affiliated group would probably do better to file separate returns. When there are sizable

inventories, the affiliated group would do better to file a consolidated return thus eliminating these paper profits.

The value of a consolidated return falls largely in the area of loss corporations. Seemingly strange deals have been made where loss carry-overs have been considered in the negotiations. The intent, of course, is to retain the loss carry-over of a purchased company, and to use the loss to reduce subsequent taxable income. It has been established under the 1939 Code that losses of the subsidiary prior to affiliation may be carried forward into a consolidated group and deducted from post affiliation income of that subsidiary only. The rule applies to the 1954 Code as well. Under the 1939 Code apparently the only requirement to retain the loss carry-over was to keep the corporation in existence. However, *Section 269* and *Section 382* of the 1954 Code now embody all the restrictions of the loss carry-over provisions to subsidiary acquisitions, so that the carry-over may not be sustained without continuation in the same line of business, in the same locale, and only if the acquisition did not have a tax avoidance motive as its primary purpose.

The working out of these rules presents some extremely interesting possibilities. For example, what would be the effect of merging a profit corporation into a loss corporation and then bringing the resultant corporation into a consolidated group? It would seem that the losses of the loss corporation suffered prior to the merger could be used by it to offset the post merger gains of the profit business, absorbed in the merger, and any remaining loss could be brought into the consolidated group. Until recently this presumption may have been acceptable, but a recent decision casts a

WHY THE CONSOLIDATED RETURN?

History	Corporation A is a successful furniture manufacturer. In 1954 it organizes a wholly-owned subsidiary, Corporation B, to operate a retail furniture store in another State. In 1956, for the purpose of providing a further outlet for A's expanded production, A buys 100% of the capital shares of Corporation C, which owns a retail furniture store and has a 1955 loss carry-over of \$100,000.				
Summary of profits and losses; the problem stated	Year	A Parent	B Subsidiary	C Subsidiary	Consolidated
	1954.....	\$100,000	(\$ 75,000)	\$ —	\$ 25,000
	1955 (C's loss—\$100,000).....	200,000	25,000	—	225,000
	1956.....	300,000	100,000	(10,000)	390,000
	1957.....	(400,000)	200,000	75,000	(125,000)
The solution	1954—Elect to file consolidated return 1955—Must file consolidated return 1956—New right of election; file separate returns 1957—Elect to file consolidated return				
Detailed solution for 1957	1957 consolidated net loss (\$125,000) Carry forward C's loss prior to affiliation (75,000) 1957 consolidated net loss, per return filed (\$200,000) Parent A will carry-back its 1957 unused consolidated loss of \$200,000 to 1955, and file a claim for refund to recover 1955 taxes. Subsidiary C has a \$35,000 unused loss carry-over (\$100,000 + \$10,000 — \$75,000).				

good deal of doubt upon this proposition. On May 27, 1957 the Supreme Court rendered its decision in *Libson Shops, Inc.*, affirming the decision of the U. S. District Court (*CCH Par. 6991—U. S. Tax Cases*). Briefly, the taxpayer, a corporation, provided a management service to 16 retail stores, each a separate corporation. The 16 corporations were merged into the 17th management corporation. Three of the 16 corporations had loss carry-forwards, which the acquiring corporation sought to use in its first return. The Court held that notwithstanding the extinguishment of the separate corporation structures, the loss attributes applied only to the separate stores, which continued to have losses after the merger, and therefore could not be used to offset income of other stores (earned after merger) in the same corporation.

The *Libson* case, while it did not apply specifically to a consolidated return, will undoubtedly have repercussions in the field of consolidated returns. The Supreme Court decision makes much to-do about the fact that

the 17 corporations could have elected to file consolidated returns, and by pooling their income and losses taken advantage of the losses of the three corporations. Now, by following the reasoning of the Court, if three loss corporations were merged into one member of an affiliated group, thus becoming part of the affiliation, it would seem that the unused losses of the merged corporations could not be deducted (1) from the post-merger income of the acquiring corporation except insofar as the losses offset income of the merged segments of the business; and (2) by no means could the losses be extended to the other members of the affiliated group. Furthermore, the sense of the Court's opinion would seem to indicate that if the parent had pre-affiliation losses it would not be able to deduct these losses from its affiliate's income after the affiliation.

There is a good deal of doubt whether the *Libson* case which was decided on the basis of the 1939 Code, will apply to the 1954 Code. The implications, however, are serious

and although it is too early to know what the Commissioner intends to do about the *Libson* case, it certainly bears most intelligent watching.

A third case recently decided (*American Pipe & Steel Corporation, CA9—4/17/57 (CCH Par. 9590—U. S. Tax Cases)*), illustrates what might be attempted, although the right to benefit was denied the taxpayer. The taxpayer acquired an interest in a defunct company with tax losses of \$400,393.91, for a total cost

of \$11,248.96. Through consolidated returns, the losses of the acquired corporation were deducted from profits of the acquiring corporation in four years amounting to \$574,949.17 reducing same by \$400,393.91. The Court denied the deduction on the basis of 1939 Code sections 129 and 141 (a), corresponding to 1954 Code sections 269 and 1501, ruling that the acquisition of the subsidiary had no basis other than tax reduction.

THE KEY TO THE COMBINATION

By PHILIP G. MOON

We are all familiar with the Arabian Night's tale of *Ali Baba and the Forty Thieves* and with the easy combination which opened the cave containing the vast store of riches which the enterprising thieves had collected. Unfortunately, the modern businessman does not have available any similar "Open Sesame," no comparable magic words that will automatically open the doors of a bank vault so that he can get the money he may need in order to carry on or expand his business. The modern business man does have available, however, a combination which frequently makes it possible to secure money from a bank in the form of a legal loan, and that combination, which is usually referred to as the "three C's of Credit" (Character, Capacity, and Capital), is generally most effective when it is accompanied by an unqualified audit by an independent certified public accountant.

It is with this key to the combination, the unqualified audit report, that the present paper is particularly concerned. We bankers see many reports in the course of our work, naturally, and not all of them are the "Open Sesame" to ready credit

which they ought to be. Not all of them give us the information which we feel we need or give us evidence that we can rely on them in the manner in which would like to be able to rely.

In this connection, we recognize, of course, that there is need for continuing education on the part of both bankers and accountants. Certainly we bankers need to know a great deal more about auditing standards, about the procedures followed by CPAs, and about the professional character of your relationships with your clients. In addition to further education of this sort on the part of bankers, however, we recognize that further education is necessary on the part of the CPA relative to the broad requirements of bankers and as to the banker's analytical methods of studying statement figures and supporting data in determining his loan decisions. Emphasizing that we bankers are fully aware of our own shortcomings, it is with this other phase of the problem that I should like to dwell at this time, citing some examples of what may be questionable accounting practices and lack of full disclosure which combine to make our

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work of effective credit granting more difficult than it otherwise might be. Here, I think, I should point out that I am not discussing audits where insufficient work was done because the client was unwilling to pay for a more detailed examination. Bankers, I believe, are gradually beginning to realize that auditors can only be expected to do that for which their customers are willing to pay, so there is no thought of criticizing the insufficient audit where the client was not willing to pay for a full audit, but rather the audit which does not meet your own professional standards or is not what it apparently purports to be.

An independent CPA in Detroit prepared an audit report for a company borrowing from us on security of accounts receivable and inventories under a letter loan agreement. In this report the public accountant failed to observe that a prior assignment of accounts receivable had been given to an important merchandise supplier under a continuing arrangement with that supplier. Neither did the CPA make any reference in the report to the assignment of the accounts to us nor to any of the other features of our loan agreement. In subsequent investigation we found that he was fully aware of both assignments. We feel that this report, although supposedly an audit, certainly lacked full disclosure of some very material facts about which any other credit grantor would be interested, and, in the one case, certainly a fact in which we were interested since it indicated that our assignment was not a first assignment—somebody was in ahead of us.

Again, a firm of practicing public accountants prepared audit reports for two affiliated companies. In the instance of the first company, a ma-

terial assessment for additional income taxes was not shown nor was a substantial contingent liability representing a guarantee of the affiliate's obligations disclosed. Later it was discovered that one of the partners in the firm of CPAs had a 10% interest in the ownership of the affiliated company.

Naturally, none of you would be guilty of this sort of thing. It is too obvious. These are the blatant omissions or errors that we see only occasionally. Here is a third illustration, however, that may strike a little closer home.

A large nationally known, well-rated accounting firm of good standing issued an unqualified report on one of our customers at the end of its last fiscal year. The company borrows from us on a long term basis under the conditions of a fairly typical loan agreement in which there is a working capital covenant, a dividend restriction, a limitation on fixed asset expenditures and a number of other restrictions. The auditors commented on the agreement in their report. They commented on the dividend clause, that is, on the amount of surplus that was available for the payment of dividends. They commented on one or two of the other covenants. They made no mention in the report at all about an obvious default in an over-expenditure of moneys for fixed assets.

It was a long form report and they included a detailed analysis of the funds spent on fixed assets during the year. The amount shown totaled approximately twice the amount allowed in the loan agreement. And yet they made no comment at all indicating that this violation existed. Under the terms of the loan agreement, the credit was in default and the bank could have called the loan

or placed it on a demand basis.

This company has a fair number of outside stockholders and is one which seeks general credit in fairly large amounts. We feel that this audit, whether from carelessness or otherwise, certainly inadequately disclosed the facts. Furthermore, although the auditors in this report gave a good and detailed analysis of the notes and accounts receivable and a complete aging (for which we realize they do not take the same responsibility as they do the basic information) and, although this detailed listing showed a great deal of slowness and some question, at least in our minds, as to the collectibility or goodness of all of these accounts, there was no reserve set up against the receivables of any kind, and no comment on its omission or statement to the effect that such was not necessary. The matter was just passed over. This is a type of lack of disclosure which we occasionally see and which bothers us in reports by auditors who we feel know better—auditors who certainly don't do these things through intent to defraud.

The second problem which I'd like to discuss briefly is the inability of bankers to obtain adequate information regarding the background, character, and reliability of accountants that are not known to us. This is a perennial problem that has been faced by bankers for many years, and we've discussed it through our cooperative groups on many occasions.

How competent is an auditor? To what extent can we rely upon his opinion? He is a CPA. He is a member of the state Association; perhaps a member of the AICPA. Such memberships help us a great deal. We feel that they indicate the auditor is interested in keeping up with his profession; that he has a desire to im-

prove himself and to know what is going on. But we can't always tell whether he belongs to your organization in name only or whether he really believes in your standards and in the things which your organization is trying to do. Does he adhere to those standards? Who has had experience with his work? Whose books does he audit and how well does he audit them? In other words, can his opinion be relied upon?

As an example of this, I would ask you how much responsibility the following auditor is accepting and to what extent we can rely upon his work. We received a statement recently on an auditor's letterhead with a bound letter in the front of it saying: "I have audited your books and records for the period ended June 30, 1957, and I submit herewith the following:" Then he listed the balance sheet, the operating statement and surplus reconciliation and went on briefly to say that the cash was verified but the accounts receivable were not verified and that the inventory was taken as submitted by the management without independent verification. The letter was signed by the auditor who is, incidentally, a member of his own state society and of the American Institute of Certified Public Accountants.

What does he mean: "I have audited?" It is obviously not an audit. He didn't do any of the basic things needed to verify the principal assets. Such a report leaves us with the feeling that we're not able to tell in any report that we see by this auditor whether he means exactly what he says. He would do better, before issuing such a report, to place himself in the position of the uninformed reader who may have to decide what has been done, based simply on seeing the report.

Bankers are hard put to evaluate this risk—how much reliance to place on the auditor. We can find out about the borrower, we can find out about his past records, his capital and his earnings, but what about the independent CPA? His opinion is often a major factor to us in deciding about loans because his report gives us assurance that the figures are at least reasonable to the best extent possible.

We feel that this ability to find out about accountants is also important to you people. It is important to the small CPA—the CPA with local practice, because if the banks can't find out enough about him they're going to be reluctant to accept his figures and they're going to let their customers know that.

Further on the question of reliability, I would like to quote a statement from a talk given by Arthur L. Nash, Manager of Brown Brothers, Harriman & Company, a large private bank in New York City:

"We still face the problem, and probably always will, of the auditor who condones unusual methods of handling accounts in order to reduce taxes of his clients. Of course there are legitimate methods of reducing a tax bill, but I have known individuals who present an audit report and imply that the earnings were much larger than shown—with substantial 'secret reserves' in certain areas—and ask the bank to concede a higher working capital than shown by the balance sheet for that reason. Some might say that, from a creditor's point of view, such a statement would offer better protection as working capital would be lower in the report than it actually was. That is not the point as I see it. My concern is, how would the borrower and the auditor act when, instead of writing down assets to save taxes, it was advantageous to write them up to save the company! In the last analysis we always come back to the integrity of the auditor."

As I have said, banks and others have real difficulty in obtaining enough information to evaluate it.

In the preceding paragraphs there have been cited a few examples of what appear to be questionable practices on the part of the practicing public accountants. Probably most of them do not apply to the readers of this article. In our own profession of banking, the ones who need training in proper credit ethics seldom come to the meetings where such things are discussed, and I am sure that much the same is likely to be true in the public accounting profession. What can be done about this? Your societies have indicated, in many cases, that they are anxious to police their own professional activities. In many instances this is difficult to do since it is hard to get specific examples of questionable practices. They simply do not have available the reports that we bankers see.

Last spring, Robert Morris Associates National Committee on Cooperation with Accountants began a survey of our members in the 22 chapters around the country, through the Chapter Committee Chairmen and others in the various areas, regarding this problem—"What can be done to help accountants in policing their profession?" We have much to gain from it. We are the ones that want to see the policing done and we are the ones that have to cooperate to do it. I received 20 to 25 answers, all of them different. I received *no* solutions.

Many leading bankers around the country indicated that they have been working with accountants in their areas on this very problem. They feel that it is an important problem and one to which we event-

ually have to find a solution. There are two stumbling blocks, which were mentioned by almost every one of the replying bankers, which make it difficult for a bank to report on a poor audit to your association or to the state accountancy board. The first of these is the bank's natural aversion to legal involvement. We bankers don't want to be sued for ruining an auditor's reputation and we don't want to be third parties to such a suit against your society or any one else. Secondly, accountants are often good friends of banks in sending new business to them, and we don't want to lose that friendship or to lose any customers because of offending their accountants.

I do think that there seems to be a gradually increasing unanimity on one thing that bankers can do. We can go back to our customers about improper audit reports. They own the report. They paid to have it done. If it's not adequate we can go back to the customer and point out why

it's not adequate; why we're not willing to accept it. The auditor who performs work that is sub-standard, either fraudulently or carelessly sub-standard, naturally, is going to suffer from it.

We hope to take one further step. We hope to arrange, through mutual cooperation of the banks where several of us have received unsatisfactory reports from the same accountants, to report such violations directly to your organization so that positive policing action can be taken. Where either fraudulent or very poor practice exists, actual punitive action can be taken.

We feel that this is a problem that is important to you and important to us. Bankers are working on it and will continue to do so. We know that many of your state societies are working on it and we are certain that the end result will be better audit reports and better aids to the Combination That Will Open Most Any Vault.

AUDITS ON SHORTAGES AND EMBEZZLEMENTS

By J. B. CARSON

There are so many interesting, unusual, and often perplexing situations which the auditor encounters when bookkeeping concealment of defalcations has been attempted that there appears to be relatively little benefit to be derived from any attempt to discuss in detail the applicability of specific auditing procedures to the great variety and, in many instances, complexity of shortage situations.

In giving this initial thought to the development of the topic, it is natural that some inquiry be made as to the nature and extent to which existing published material might be helpful. This investigation, although not exhaustive in the present instance, quickly led to the conclusion that textbooks and other literature on auditing subjects have been almost unanimous, if not entirely so, in their omission of any attempt to discuss the auditors' risks and responsibilities where the audit of fraudulent accounts is involved. Perhaps it is this very absence of available literature which may help to lend some practical importance to the subject which I am here discussing.

In mentally reviewing my own experiences with shortages, I think two things have impressed me most. First of these is the great opportunity

afforded for the employment by the auditor of a degree of imagination, ingenuity, perseverance and resourcefulness not generally called for in a normal audit engagement. Second is the great variety and frequency of embarrassing situations in which an auditor may find himself if he is relatively inexperienced in examining and reporting on dishonest accounts and, in consequence, fails to give (a) adequate advance consideration to the planning and execution of his work, and (b) much thought and care to the preparation of his working papers and report, the selection of personnel who are to assist him, and the adequacy of his papers in relation to their almost certain examination by interested third parties.

With the foregoing in mind, an attempt has been made to outline, from sometimes not too pleasant memories of my own, various "pitfalls" which confront the unwary examiner of falsified accounts and some of the steps which can be taken to avoid them.

Such pitfalls and their avoidance seem to fall within the following four major categories and I shall discuss them in the order mentioned:

1. Agreements with the Client and Initial Representations to Him

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2. Advance Planning for the Engagement
3. Performance of the Work
4. Reporting of Findings.

It is my personal view that axiom number one on any engagement which is expected to disclose fraudulent manipulation of the accounts, even though initially believed to be minor, should, barring most unusual circumstances, be fully and thoroughly discussed with the person or persons responsible for approval and payment of fees. Among the points which should be covered in such a discussion are the following:

1. It should be adequately explained that what may presently appear to be petty could (depending on your knowledge of the personnel and records involved) develop into a very significant loss and that neither you (nor any accountant for that matter) could be reasonably expected to estimate the time or ultimate cost involved. It should be explained to clients who have had no previous experience with embezzlers, and indicated to others, that you cannot estimate how much of your time will be required by surety company representatives and possible later litigation and that payment for such time is the responsibility of the client.

As early as possible you will need to become acquainted with the attorney who represents the client. Bond coverages will need to be reviewed and this offers a convenient opportunity for calling in the attorney. In most instances he will give you good backing as to the nature and extent of detailed checking necessary to support an adequate proof of loss and will support your advice to the client that the bonding company will normally give no aid on the proof of loss and will frequently leave no

stone unturned to contest it, especially if the loss cannot be positively proved to have resulted from the dishonesty of covered employees or if uncertainties exist as to the date and amount of each misappropriation.

2. Establishment of mutual confidence and friendly relationships between you and the client's attorney at the outset will prove most helpful to the auditor whose experience with the aspects of what is legally acceptable and desirable from the standpoint of proving losses has been limited or nil. To those of long experience in such matters, his help is still needed in developing leads and evidence not ordinarily available from the accounting records and supporting data and in resolving legal questions relative to various accounting determinations. Almost every shortage will involve several legal questions of specific problems which even the auditor of long experience in the examination of defalcations has not previously encountered. If the client has no retained attorney, you will be wise to suggest that the early retention of competent legal counsel is most advisable.

3. Another important phase of initial agreements with the client relates to appropriate working quarters and freedom of the auditor to decide which of the client's employees shall have access to the records under examination, at what times, and in what manner. This phase of the discussion should also include desirability of allowing the auditor to make final decisions on which records examined are to be stored for future needs and in what manner.

4. If strong evidence points to the guilt of an employee still in custody of cash or property from which thefts are believed to have occurred, it is advisable that you clearly indicate

to the client the possibility of his making a large and final "grab" during progress of the audit unless he is relieved of his duties or positive internal controls established to prevent such action. It is embarrassing on the witness stand to have to admit that thefts continued during progress of the audit and this may weaken value of the auditor's testimony to the jury.

5. By all means avoid calling in an employee and demanding a confession on the basis of a preliminary conference with the client or evidence later developed by you. Taking or asking for confessions is, in my judgment, a matter to be decided upon by the client's attorney, the surety company involved, if any, or law enforcement officers. Should the suspected employee start a voluntary confession in response to inquiries about his accounts, I believe it will, in many instances, be best to suggest to him that each of you may find it difficult to recall later the exact details of what he proposes to say and that you prefer to have a stenographer make notes, preferably in the presence of his employer. If he balks at this procedure, you might suggest that either of you write down his conversation as he talks, making a carbon copy for his files. In either case it would, in my judgment, be advisable to add a final sentence to the effect that the above represents a voluntary statement on his part, and he has neither been threatened, intimidated nor influenced by promise of reward or whole or partial immunity from civil or criminal proceedings against him in the making of the statement.

At best, the auditor is in a somewhat undesirable situation if a confession is started with no one else present. He cannot well afford, by

demeanor or too emphatic suggestions as to more formal procedure, to shut off a source of what might prove to be highly valuable information and much saving in time. Should the personality of the employee and existing circumstances justify a belief that information may be withheld if a written statement is requested, it will certainly be best to "listen him out" and then proceed with suggestions as to his bringing in the employer and reducing his confession to writing. The risk here is that, after he has had "his say" to you, in private, he will be most reluctant to repeat it to his employer when he might have been willing to talk before both of you if initially so requested. This is just one of those situations where the auditor is compelled to use his best immediate judgment. My only advice here would be to learn as much as possible about the suspected employee and the nature of the wrongful acts involved before you expect to find yourself alone with the suspect.

6. Avoid giving the client estimates of recoveries in relation to bond coverages involved. If the full coverage is realized it will usually suffer reductions by your own fees, not to mention those of attorneys and the expense of producing witnesses from whom favorable testimony is expected should subsequent litigation result.

7. It has been my experience that it is usually advisable to leave tax aspects of shortages and corrections of faked accounts out of the discussions leading to an initial agreement for the engagement. In most cases, not enough is known about the facts involved to permit a discussion of any value. Should these matters be brought up by the prospective client, it will normally not be difficult to satisfy him with general answers and

the assurance of subsequent full discussion as indicated by information developed. If litigation results, it is also better that time devoted to ascertainment of the client's loss be billed under a separate agreement from that devoted to tax matters and re-statements of falsified accounts not needed to support proofs of losses.

8. Be sure, in preliminary discussions, to emphasize to the client that the work involves great responsibilities to each of you; that you are subject to suit in the event of criminal prosecution on the basis of evidence introduced in civil proceedings which might result in a "not guilty verdict" even though the evidence be quite convincing to an unbiased person of high school level intelligence; that his full co-operation is essential in developing evidence from sources other than his own records, even at the risk of having customers or suppliers suspect inadequate accounting procedures; that your most capable and permanent staff members will have to be used and that a substantial portion of partner time will be involved to insure the proper protection of his interests in the event of continually postponed and delaying litigation.

9. It is most important that you obtain as much advance information as possible concerning the reputation for honesty and fair dealing of the official personnel whom you expect to retain you, and of the financial ability of the client to pay for the work involved without looking to possible recoveries from the shortage for the source of your fee.

10. Having fully informed the client relative to the uncertainties as to time involved, the necessity for use of our best and most experienced personnel, the reasons for most complete and adequate working paper

records of our findings, and the other matters discussed above, we are now in position to have a full and frank discussion of compensation. Here, I see no justification for any basis other than top per diem rates and expenses. Of course, in the event you have made partial prior audits of the accounts involved and feel in any way responsible for failure of the irregularities to have been detected at an earlier date, your own conscience, good judgment and previous and anticipated future relations with the client will have to be accorded due weight. Of course, I am now talking about shortages of significance and not petty thieving from imprest funds.

It is my further view that, where the anticipated work is expected to occupy the time of two or more men for more than one month, progress payments are indicated, particularly if public funds are involved or the relationship which exists is not one of an old satisfactory client in excellent financial position.

In discussing fees, the client should have your assurance that you will keep him, or his representative, informed at frequent intervals as to the status of work finished to date, work planned until the next conference, and reasons for what has been and will be done. The client would, of course, be free to demand at any time a discontinuance of your work on condition of payment of fees earned to date, a situation which should normally not arise.

In the event the client is insistent upon a maximum guarantee, it is, I believe, preferable to suggest a temporary retention at per diem rates during the period in which your efforts would be directed to a survey of the system of internal control, records involved and such other mat-

ters as might bear upon amount of the loss and nature and extent of probable work involved. This is a flexible sort of thing and gives you additional time to impress the temporary client with your ability to deal vigorously and effectively with the particular situation involved.

After such a preliminary survey, you will certainly be in much better position to weigh the risks involved, if a maximum fee quotation is still required, in quoting a fee expected to bear some relationship to maximum work considered possible and, more important still, to justify it in considerable detail should this become necessary.

As soon as a verbal understanding is reached in regard to fee arrangements, it should be made the subject of an appropriate written agreement. I believe that, under normal conditions, a carefully drafted proposal prepared by the auditor, with a space for written acceptance by the client, will be sufficient. This may be qualified by saying that, if you are dealing with a governmental sub-division, be sure that you have written approval of the official or officials having legal authority to incur a liability of the amount anticipated and that at least seventy per cent of the anticipated total fee is payable as the work progresses, at intervals of not less frequency than monthly billings payable within ten days from date of invoice. Unless this fee arrangement is provided, I would certainly seek the assistance of competent legal counsel as to your collection position under any proposed contract. Here again, I have in mind work involving fees which will be substantial in relation to the auditor's financial position and the possibility of his willingness to risk some financial loss in the event of failure to collect. In our present

economy, I can see no excuse for a risk of much time. Even in the case of a sole practitioner faced with the possibility of considerable idle time in getting his practice started, I believe the attempting of substantial work for which pay is uncertain to be unwise unless the accountant is fully satisfied that the agreement will lead to continuing profitable work over a period of years. It has been my experience that such situations are practically nil and that the starting practitioner will do better to devote his free time to expansion of the service being rendered several existing clients and the making of ethical contacts which will bring in additional clients.

The preceding discussion of this matter of initial understandings with the prospective client has been somewhat lengthy. I hope that this is justified by your own experience as well as mine, to the effect that this matter of initial representations is an area which probably gives rise to more difficulties, if not properly managed from the very beginning, than any other phase of "shortage" examinations, barring plain incompetent and unnecessary work.

Having had a full and complete meeting of the minds on terms and conditions of the engagement, let us now discuss the matter of advance planning.

I have already made some reference to use of your best personnel, and this is most important for reasons which are obvious from other phases of the discussion. Here you have to consider staff capabilities and probabilities, not only from the standpoint of competence satisfactorily to conduct planned auditing procedures but also to summarize clearly and explain their findings to the client, the surety company representatives, and

possibly to jurors. Some very capable auditors just cannot put their findings into words adequate in situations of this sort.

Generally, it will be most desirable for a principal or partner to participate in the examination to the extent necessary for him to carry the chief burden of explanation and testimony as to ultimate findings. In choosing among staff members of about equal professional competence, due weight should be accorded years of auditing experience as this, as well as personal appearance, carries weight with a jury. Usually those who have had prior experience as witnesses and are known to be capable in this respect are preferable to the relatively inexperienced. The man who has had considerable experience in dealing with examiners of tax liability and can express himself clearly and forcefully on a person to person basis will generally make a good witness even though he may have had no prior courtroom experience.

The matter of expected permanence is also a factor. It may be three or four years from completion date of your examination before the end of court proceedings. It is desirable that those who participated in the audit still be your staff members when they appear in court, but this is by no means essential. However, this factor should not be entirely ignored in the initial selection of staff personnel.

Prior to the commencement of field work, all who are to participate at a senior or higher level should familiarize themselves with accounting methods of the trade or industry to which your client belongs and with the nature of its physical operations as far as possible. Staff men who are experienced in auditing the particular operation in which your client is

engaged, assuming other factors about equal, have naturally been utilized to the extent available. They will be of assistance in initial briefing and can be used for this purpose even though not available for field work. Careful study should be made of all such financial and operating reports on the client's own business as are available for the shortage period and three to five prior years.

While this preliminary study is a "must" for those at senior or higher level, others who are to work on the engagement should be encouraged to participate in order to improve their professional knowledge and possibly their usefulness on the assignment.

Prior to the commencement of any substantial amount of field work, the partner and senior who are to be in active charge should complete an even more thorough survey of the degree and extent of internal controls employed, records maintained and employee duties than is customary on an initial audit engagement where no shortage is involved. Particular attention and inquiries should be directed to the possible availability of records from which no bookkeeping entries originate but which may prove almost invaluable in tracing the amounts of an employee responsibility for defalcations.

In my judgment, any shortage situation which could develop into a significant matter merits a great deal of initial partner-level investigation, thought, and planning before time consuming and exhaustive audit procedures are prescribed. Such questions as—(a) how much of collections represent actual coin and currency subject to theft, as opposed to checks? (b) what are the sources other than client kept records, such as the reciprocal accounts of debtors and creditors, from which pertinent and

often more reliable information than that available from the client's records may be had? and (c) is the work of detectives or other independent investigators indicated in the development of information which could have a significant bearing on scope and nature of audit work considered necessary?—such questions, I repeat, merit early and continuing thought, study, and discussion by the principal involved and his incharge assistant.

I feel that I cannot emphasize too strongly the advisability of planning as full recourse as possible to non-client kept records in the examination of fraudulent accounts. At one time such recourse involved a great amount of copying of data to be independently confirmed. This is now greatly simplified by the use of photographic methods for making copies of records to be compared, whether those of the client or his customers or suppliers.

Let me caution against planning too comprehensive an investigation of any one class of transactions without related planning of sufficient examination of all classes of transactions in which irregularities are considered probable, since it is possible to get oneself in the position of having made a time consuming examination of one mass of detail for a long period when audit of another class of transactions, for even a month, might disclose the method employed in concealment of a chain of thefts.

Perhaps here it will be well to mention briefly a few specific procedures which will enter into the preliminary planning of most work relating to the embezzlement of cash. Barring unusual circumstances, it is desirable to exercise audit control over cash, receivables, and securities until examination as of a specific cut-

off date has been completed. Planning, therefore, will naturally include appropriate arrangements with the client, including delivery to the auditor of all bank statements and cancelled checks as of the cut-off date and the independent confirmation (usually positive) of receivable balances as of such date.

Generally, it may be best to select a short period, usually the month immediately preceding cut-off date for verification of balance sheet accounts, to make an initial comprehensive examination of all classes of transactions. However, I would not plan any extensive work of this nature from a standpoint of commencement until it can be satisfactorily related to the results of independent confirmation procedures employed.

While most clients will want the "answer" at the earliest possible moment, one will seldom encounter a situation where the client will insist upon the immediate undertaking of procedures which might later prove to have been unnecessary when independent confirmation results become known.

As to actual conduct of the work, it is axiomatic that the examination should be made in accordance with the generally accepted standards of auditing which have been adopted by the accounting profession and which require no repetition here.

Generally speaking, most defalcations will follow a standard pattern of misappropriation and attempted concealment. Valuable clues as to the nature and often the probable extent of the shortage involved will usually be disclosed by the results of balance sheet account independent confirmation procedures which were briefly reviewed in the discussion of advance planning. Once the key has been obtained to this apparently

standard pattern of theft, if it is obtained in the manner just mentioned, it will probably be best to make a preliminary trace of suspect transactions to a considerable extent beyond the amount of bond coverages involved in order to estimate recoveries anticipated. If the tentatively determined thefts materially exceed maximum possible recoveries, it would be nothing short of dishonest not to inform the client fully as to tentative findings in this respect. The matter of potential recoveries from the guilty, in addition to bond coverages, will need to be considered. In some instances a complete examination of all accounts may be indicated and in others it may be desirable to limit the auditor's work to the establishment of proofs of loss somewhat beyond the amount of maximum recoveries considered possible. Discussions of any decisions on these matters usually indicate the participation of a competent attorney.

More than ordinary care will need to be exercised in the preparation of working papers which are likely to be retained as a permanent record. While some accountants may advocate retention of all papers and memoranda compiled in shortage situations, others advocate the destruction of all memos, instructions, and correspondence which served a temporary purpose only and are not needed to support one's report and possible court testimony. The principal reason for this suggestion is that much of such matter may reflect differences of opinion as to whether certain transactions are honest or possibly fraudulent, and other questions in process of resolution, which have later been solved to the satisfaction of all concerned. Your working paper file supporting a shortage determination is going to have the close scrutiny of a

good many people including, in many instances, capable accountants and attorneys representing interests opposite to those of your client. Some will not hesitate to use your private correspondence and tentative memos to attack the validity of final results reported. Therefore, it may be desirable to destroy all that is not needed as final evidence and be sure as to the exactness and adequacy of papers to be retained.

In auditing shortages there are two aspects of every transaction—the improper diversion of the money or property and the omitted or fraudulent entry used to attempt concealment. By way of illustration, let us assume the theft of money paid on account by customers. One's audit procedures will be directed not only toward ascertainment of the date and amount of each omitted or understated item and name of the debtor who remitted it, but also to the determination of the related manipulations or entry omissions used to affect at least temporary concealment of the irregularity.

If the work can be appropriately divided into segments, which is normal, avoid switching men from one phase to another as far as possible. Why? Because, you do not want to have three or four juniors testifying to inaccuracies, shall we say in cash book footings, when one could testify to this entire phase of the work had he not been switched to other routine assignments involving equal clerical drudgery.

Each class of document should be most carefully discussed with every person who might touch it from the time it reaches the client's place of business or has been prepared thereat until final disposition in the files, and this includes all copies as well as the original. This class of investigation

often discloses employee "side records" kept for their own protection or to discredit a fellow employee and break-downs in internal controls outlined as perfect by supervisory level employees.

Each phase of work contemplated should be carefully related to other phases of the accounts and examination procedures upon which it has any bearing and should be reviewed with the client, unless he is suspect, as to the probability of its having a practical application of significance. In other words, don't do a lot of checking to support something shown missing by one phase of your examination until you have exhausted all sources of possible logical explanation for that which seems to be missing.

Before going into the matter of reporting findings, it is well to emphasize briefly two or three important concluding phases of conducting the audit. Be sure that the documentary evidence owned by the client, which is necessary to support your findings, is adequately indexed, labeled and safely stored. Where public funds are involved, it is sometimes advisable that storage be provided in space to which the auditing firm and certain designated public officials have joint access only.

Be doubly sure that working papers prepared to support your findings include exact and correct references to the record, date, and folio number of the client record to which your working paper entry relates, which member of your staff is responsible for recording of the working paper record, and adequate explanation of the item or class of items involved. A recheck of all items to be reported as evidencing missing cash or property is indicated as the work is concluded; first, by the in-charge accountant as to exact

accuracy and completeness of all papers directly supporting report statements and the proper indexing thereof; second, a careful review by the principal as to matters of clarity, accessibility, completeness and judgment exercise, accounting principles, and the like pertinent to the position taken by your firm.

It is assumed that the responsible principal has been in active charge of or personally engaged in the examination and that the concluding steps of field work have included preparation of pencil drafts of the proofs of loss to be filed and report to be submitted, as far as statements are concerned. In making his final check of working papers filed, the partner or principal will, of course, be sure that all support for such drafts is readily accessible and in proper form.

We have now reached the last phase of the subject, namely, completing initial drafts of the formal report. Here one should rely heavily upon the advice of the client's attorney and possibly his own.

Assuming that there has been considerable discussion between the accountant, the client, and the client's attorney, as already suggested, during progress of the audit, there has probably been a meeting of the minds as to the form and detail in which the exhibit and statement sections of the proof of loss and the report are to be submitted.

I shall deal very briefly with the proof of loss since, in my judgment, it is a representation of the client, even though all accounting facts included have been developed by the accountant. Practically all surety companies, if not all, will provide a brief standard form on which to state amount of loss sustained, period in

which it is alleged to have occurred, and applicable bond number, and the like.

After the auditor has satisfied himself that the client and his attorney fully understand the accounting determinations upon which the claim is to be predicated, it is largely the responsibility of the attorney to advise as to the scope of explanatory comment to be included. If the claim amounts to five thousand dollars or more, it will usually be subjected to field investigation and a check against the client's records, at which time verbal explanations will be in order. Therefore, it is probably just as well not to attach a great amount of explanatory detail in support of the proof form so long as there is adequate itemization of the amounts going to make up the total loss claim, date on which each such item became a loss, kind of property involved, and how taken. As far as practicable, all items of the same class, such as cash, should be included in a separate grouping, with sub-groups sub-totaled according to the manner of misappropriation, i.e., such as "amounts paid by debtors at collection window number three which were not remitted to company Treasurer, with funds represented to constitute total collections received."

As to the auditor's own report of his findings, this is, of course, a special purpose report and its content will be governed to a considerable extent, in most instances, by wishes of the client, so long as the auditor is accorded full freedom to make whatever disclosures he considers to be indicated by the terms of his engagement and his own professional responsibilities in the existing circumstances.

The client can, of course, be guided to a very considerable extent by tact-

ful suggestions of the auditor relative to report contents, especially with respect to matter which might be dangerous from the standpoint of possible responsibility. The auditor must be prepared to report and accept responsibility for his findings of fact from records examined, but this will have to be done with extreme care so as to avoid stating as a fact something actually based on "hearsay" evidence as far as he is concerned.

Generally, there are probably very few instances in which statement content of the report on a shortage investigation cannot be identical with statements submitted in support of the proof of loss to the extent that such statements represent work of the auditor. Any attempt to present factual findings in one manner in the audit report and in a different manner in the proof of loss will usually lead to the unnecessary confusion of interested third parties.

The reasons why both text and statement section of the report on a shortage should be worded in language designed to be understandable by an educated person who is not an accountant are obvious. Even at the risk of what may appear to the average accountant to be unnecessary simplification, it seems that the shortage report should contain at least a summary of findings which an intelligent layman will not find too difficult to comprehend.

The nature and scope of reports on shortages are too divergent to permit a discussion of specific problems. Perhaps a few more generalizations and some "don'ts" may be in order. Of course, I am here expressing my personal views. Some may entertain different ideas.

My preference is to make the text

section of the report as brief as is consistent with the requirement of having it understandable. In my judgment, the report should be addressed to the Officer or Board which employed you and paid your fee. Why spread legal responsibility further?

The report will naturally state the period covered by the examination and should index the statements, exhibits, and schedules included therein. I prefer omission of any attempt to discuss scope of the work performed in what might be termed a "scope of work" paragraph. It seems preferable to comment on examination procedures employed only to the extent considered essential, in separate discussions of each statement in the report.

Following the opening paragraph of the letter accompanying the statements, I consider it generally desirable to summarize what the statements show, with whatever related clarifying comment is considered necessary.

Generally, a discussion of each major statement submitted is then in order. Usually, the specific client records and related confirmation upon which the statement is predicated should be mentioned. To avoid repetition as to the identity of records examined, it is often advisable to use an introductory paragraph immediately preceding the discussion of statements submitted. This might read somewhat as follows: "All books, accounts, and records to which reference is hereinafter made, unless otherwise indicated, are those submitted to us for examination and identified to us as being the accounts and records in which all transactions affecting cash and other property owned by the company or under its control in an agency

capacity, were required to be properly recorded."

Now a few "Don'ts." Avoid discussion of the poor condition of records and absences of internal controls if your report is intended to support the recovery of losses by your client. It will weaken his position. If he wishes recommendations, criticisms, and suggestions, explain to him that your correspondence files and those of the company are available to those who may contest the proof of loss filed. It will be better to give him a personal, unsigned, plain paper memo to be his individual property and yours and kept at your personal residences when not in use.

Don't refer to any officer or employee by name in your report or to any record as having been kept or under control of an employee by use of his title, unless prefixed by the statement that you were informed to this effect. Then be sure to have in your files a record of who informed you.

Do not attempt to fix personal responsibility for wrongful acts in any written communication, especially not in your report. Confine the report to a factual statement of what was shown by, or ascertained to be omitted from, the records you examined.

If inferences or conclusions must be drawn, be sure to express such as the judgment of the auditor, based upon the records examined and explanations furnished him, having appropriate record of the explanations and by whom furnished in your working papers.

We are here dealing with a type of report in which the statements are not representations of the client but a factual statement of what the auditor found the records to show or not to show. Therefore, in my judgment

any attempt to close with any sort of opinion statement would be inappropriate.

One further point! You may examine numerous phases of the accounts which are ascertained to be properly maintained. Don't attempt

to cover in your report on the shortage what you found to be all right. Limit the report on the shortage to essential matters related directly thereto. If the client desires supplemental information and statements, render them separately.

The Illinois CPA Examinations, November 1956 and May 1957

By D. A. GROSSMAN AND ZELLA HALL

Another year has passed, and two more CPA examinations in the State of Illinois, as well as in other states, have become history. Examinations are held in Illinois in May and November in which candidates write for two and one-half days in attempting to qualify for the certificate of Certified Public Accountant.

In Illinois the official title, Certified Public Accountant, was established by state statute in 1903. This statute has been amended on several occasions since that date, the last such amendment having been passed in 1957.

Illinois uses the uniform examination questions which are prepared by the American Institute of Certified Public Accountants. One session of this uniform examination is devoted to the Theory of Accounts, one to Auditing, one to Commercial Law, and two sessions to Accounting Practice. The examination covers a total of nineteen and a half hours.

The State of Illinois is also now using the uniform Advisory Grading Service provided by the Board of

Examiners of the American Institute of Certified Public Accountants. This means that the examination papers are first graded by a Board of Examiners of the American Institute in New York. They are then returned to the State of Illinois where they are rechecked carefully by the Illinois Board of Examiners. On the basis of the original grading, verified by the recheck, the list of successful candidates is certified to the University of Illinois which has the responsibility, under the statute, of administering the Illinois examination and of issuing the Illinois CPA certificates. Such supervision of the examination has been vested with the University since the first statute was passed in 1903. In the course of the fifty-four years since that time the University has issued 6,704 CPA certificates. These certificates are issued by the Board of Trusees and bear the signatures of the members of the Board of Examiners, the President of the University, and the Secretary of the Board of Trustees.

The number of candidates seeking

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the CPA certificate in Illinois in the two examinations, November, 1956 and May, 1957 was 1,069. This represents an increase of 150 over the two previous examinations in this state. Of the 1,069 candidates, the following numbers were successful:

	Nov. 1956	May 1957
Passed all subjects at one time. Eligible for CPA certificate	49	45
Passed final subject or subjects under the condition rule, having previously attained passing marks in other subjects. Eligible for the CPA certificate	68	85
Total number of successful candidates	117	130

The best news, of course, for any candidate is the official notice that he has passed the examination. The next best news is that he has passed a part of the examination and has qualified for a "condition." The "condition" enables a candidate to try again, as many as three times within three years, in the subject or subjects in which he failed without the necessity of repeating the subjects in which he passed. This privilege, however, is subject to certain limitations. The condition rule in effect at the time the two examinations under consideration here were written provided that a candidate who passed the three sessions in Accounting Theory and Accounting Practice *or* the two sessions in Auditing and Commercial Law *and* who attained a grade of at least 60% in the subject or subjects failed might retain credit for the subjects passed and try again in the subjects failed. Under this rule, three trials are permitted within a period of three years from the date when the condition was attained. This

condition rule has been somewhat liberalized by the most recent amendment to the Illinois statute which becomes effective with candidates achieving condition status in the May, 1958 examination.

Of the 1,069 candidates who wrote the two examinations reviewed in this article, the following achieved condition status:

November, 1956	174
May, 1957	109
Total	283

Included in these figures are those who had achieved condition status earlier, who wrote in one or two of these examinations, who failed to pass, but who still have the privilege of appearing one or more times in the future to write in the subjects failed.

THE CANDIDATES WHO FAILED

We come now to that part of the examination which is not so cheerful. There are always a number of candidates who fail to pass, or who fail to attain condition status. In these two examinations, the number was 528, distributed as follows:

November, 1956	252
May, 1957	276
Total	528

THE SUCCESSFUL CANDIDATES

The successful candidates, in addition to the satisfaction of qualifying for the CPA certificate, had in store for them another very pleasant experience. They were guests of the Illinois Society of Certified Public Accountants at a dinner in one of the large hotels in Chicago and they received their CPA certificates in a ceremony which resembles a com-

mencement. The certificates were presented by an officer of the University of Illinois representing the Board of Trustees. Among the successful candidates in these two examinations were 115 men and two women in the November 1956 examination, and 128 men and two women in the May 1957 examination. Thus there were 243 men and 4 women who qualified for the CPA certificate in the two examinations discussed in this article.

For a good many years, the Illinois Society of Certified Public Accountants has also recognized the candidates who make the best grades on the examination. These candidates are presented Gold and Silver medals. This also is a part of the ceremony at the Awards Dinner. In each of these examinations, the candidates ranking next to the highest ranked so close that the Society voted to award two Silver Medals in each case. The names of the persons receiving medals in these two examinations are as follows:

NOVEMBER, 1956 EXAMINATION

Gold Medal—Wilson Jerome Besant
Silver Medals—Paul Harold Rosenfield,
Ronald Harvey Weintroe

MAY, 1957 EXAMINATION

Gold Medal—George Clarence Mead
Silver Medals—Charles J. Cook,
Cordell Jersild Overgaard

The law provides that the candidate must be at least 21 years of age to qualify for the CPA certificate. Only 21% of the successful candidates in these two examinations were under 25 years of age. The number of successful candidates in the group where the ages range from 25 to 29 increases substantially, (41%). Over 80% of those who passed were under 35 years of age. The successful candidates fall into the following age groups:

	Nov. 1956	May 1957
21-24 years of age	30	23
25-29 years of age	43	60
30-34 years of age	22	25
35-39 years of age	11	16
40 years or older	11	6
Total	117	130

Only a relatively small number of the candidates pass the examination on their first trial, about 21%; 32% passed on the second; and about 18% on the third attempt; 14% on the fourth. Thus, approximately 85% of the successful candidates passed on either the first, second, third, or fourth attempt. The table below indicates the number of successful candidates in the two examinations who passed after the indicated number of trials.

	Nov. 1956	May 1957
Passed, 1st examination	25	28
Passed, 2nd examination	41	39
Passed, 3rd examination	24	22
Passed, 4th examination	15	20
Passed, 5th examination	4	15
Passed, 6th examination	4	2
Passed, 7th examination	3	3
Passed, 8th examination	0	1
Passed, 12th examination	1	0
Totals	117	130

From time to time considerable concern has been expressed because of the apparent lack of adequate educational preparation of the candidates sitting for the CPA examination. In the Illinois law an attempt has been made to define, in general terms, the amount of education required for the examination. Thus, in the Act of 1943, this educational requirement was established as 30 semester hours of credit in Accounting, Business Law, Economics and Finance. A

least 20 semester hours of the required 30 were required to be in Accounting.¹ Statistics show that most of the successful candidates have had considerably more than this minimum amount of formal training. There is also the indication, as shown in the table following, that four years of study (which normally means a college degree) appear to enhance one's chances of successfully passing the examination.

Educational Background	Successful Candidates	
	Nov. 1956	May 1957
High school graduation plus 30 hours minimum prescribed	19	23
College degrees.....	79	85
College degree plus graduate study or further professional study	19	22
Total successful candidates .	117	130

The Illinois statute has never contained a provision requiring public accounting experience before issuance of the CPA certificate. The candidate who has the requisite preliminary education and who demonstrates on the examination an adequate knowledge of accounting and the related subjects thus may qualify for the CPA certificate without proof of experience. The following table, however, appears to indicate that practical experience is definitely helpful to many candidates in passing the examination.

Experience Background	Successful Candidates	
	Nov. 1956	May 1957
No experience.....	16	34
One year experience.....	28	23
Two years experience.....	23	25
Three years experience.....	13	14
Four years experience.....	15	9
Five years and over.....	22	25
Total successful candidates..	117	130

COMPOSITE PICTURE OF THE TWO EXAMINATIONS

Combining the results of the two examinations under discussion in this report, we find the following picture. Of the 1,069 candidates who wrote the examination, 247 (23.4%) passed and received CPA certificates. This represents a substantial improvement over the two previous examinations, when 919 wrote and 191 (20.78%) passed. It is interesting to note that this same upward trend was apparent when the two preceding examinations were compared with the corresponding earlier tests. One possible interpretation of this may be that the candidates who are coming into the examination are somewhat increasingly better prepared than they were in former years.

Of the 247 successful candidates, 94 (8.79%) passed the entire examination at one time (not necessarily the first time). This too is an increase over the two preceding examinations where the percentage was 7.94%. In the two examinations prior to that, the percentage was still lower, 6.47%. Here, again, seems to be evidence that the calibre of the candidates in the examination is improving. One hundred and fifty-three (153) passed the November, 1956 and May, 1957 examinations under provisions of the applicable condition rule. This repre-

¹ Section 3 of the new Accountancy Act passed in 1957 provides for increases in the amount of formal education required. The education requirement increases at three year intervals from the present 30 hour requirement in prescribed subjects to 60 hours, then to 90 hours and finally to 120 hours. Each interval prescribes an increase in total hours and an increase in the hours of credit in accounting, auditing, and related subjects.

sented 14.31% of the total candidates writing as compared with 12.84% in the two examinations immediately preceding.

Approximately 17.39% of the candidates in the two examinations acquired *new* condition status and an additional 9.07% who failed to pass under the condition rule still have one or two additional trials to work off the condition in the subject or subjects failed. Five hundred twenty-eight (528) or 49.3% failed to pass the examination or to achieve any condition status. In the two examinations under discussion in this article, 17% of those who passed met the minimum educational requirement of 30 semester hours in the study of accounting and related subjects, but had no college degree. This compares with 12.07% in the two preceding examinations. About 83% of the successful candidates in the two examinations had college degrees and, of this

number, 16% had graduate training or professional training beyond the Bachelor's degree. These figures correspond to 78% and 12% in the two preceding examinations. Here again is evidence seeming to indicate an improvement in the educational preparation of the candidates for the examination.

In the two examinations, 20% had no experience. This compares with 20% in the November, 1955 and May, 1956 examinations; 33% in the November, 1954 and May, 1955 examinations; and 26% in the November, 1953 and May, 1954 examinations. Fifty-one percent (51%) of the successful candidates in the November, 1956 and May, 1957 examinations had one, two, or three years of public accounting experience as compared with 33% in the two previous examinations, and 46% in the examinations of November, 1954 and May, 1955.

Opportunities for Service to the Profession

The names of thirty-seven Illinois CPAs appointed or elected to membership on committees of the American Institute of Certified Public Accountants have recently been announced as follows:

- Kenneth S. Axelson, Chicago—Committee on Management Services
- Horace G. Barden, Chicago—Committee on Auditing Procedure and Committee on Relations With the SEC
- Norton M. Bedford, Urbana—Committee on Accounting Procedure
- S. Alexander Bell, Chicago—Committee on Insurance Accounting
- W. R. Blew, Chicago—Committee on Relations With the Interstate Commerce Commission
- Carl J. Bohne, Chicago—Committee on Statistical Sampling
- Hugh M. Campbell, Chicago—Editorial Advisory Board
- George V. Carracio, Chicago—Committee on Relations With the Interstate Commerce Commission
- Richard S. Claire, Chicago—Committee on Coordination of Activities of State and National Organizations
- Max E. Hooper, Chicago—Committee on Accounting for Non-Profit Organizations
- William S. Deeming, Chicago—Committee on Professional Ethics and Committee on Nominations
- Robert L. Dicke, Chicago—Advisory Board on Accounting Personnel
- Robert I. Dickey, Urbana—Editorial Advisory Board
- Lowell C. Doak, Chicago—Committee on Membership Policy
- Hester E. Erb, Deerfield—Editorial Advisory Board
- J. P. Goedert, Chicago—Committee on Federal Taxation
- Harry I. Grossman, Chicago—Committee on Public Relations
- Carl Gustafson, Chicago—Committee on Bank Auditing
- George M. Horn, Chicago—Committee on Federal Taxation
- Donald R. Jennings, Chicago—Committee on Accounting Procedure
- Ralph S. Johns, Chicago—Committee on State Legislation
- Paul F. Johnson, Chicago—Committee on Federal Taxation
- Robert I. Jones, Chicago—Committee on Insurance Accounting
- Louis M. Kessler, Chicago—Committee on Foreign Affairs and the Executive Committee
- Jack Macy, Chicago—Committee on Estate Planning
- Robert S. MacClure, Chicago—Committee on National Defense
- E. Waldo Mauritz, Chicago—Committee on Local Governmental Accounting
- L. B. McLaughlin, Chicago—Committee on Cooperation with Bankers and Other Credit Grantors
- C. R. Miller, Chicago—Committee on Auditing Procedure
- C. A. Moyer, Urbana—Committee on Standards of Education and Experience for CPAs

Howard D. Murphy, Chicago—Committee on Relations With the Interstate Commerce Commission

Robert Penn, Chicago—Committee on Accounting for Non-Profit Organizations

Francis J. Speyer, Chicago—Advisory Committee of Staff Accountants

Joseph F. Sullivan, Chicago—Committee on Auditing Procedure

George L. Weisbard, Chicago—Committee on Estate Planning

Edward B. Wilcox, Chicago—Committee on Accounting Procedure and the Committee on Terminology

Arthur E. Witte, Chicago—Advisory Committee of Local Practitioners

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